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Capitalism and Democracy: The Long March

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Abstract

The synthesis of liberal democracy and capitalism has been a winning formula in many countries. The emergence of modern liberal democracy and capitalism though has been gradual in many parts of the world. It has been a tumultuous journey of a few hundred years. The industrial revolution laid the groundwork for modern economic growth fueled by the division of labor and technological innovations. The economic changes brought in its wake major social changes that strengthened the impulse for political participation in the following decades. The spread of industrialization encouraged further the separation and specialization of occupations that had far reaching political consequences. In the second-half of the nineteenth century political development towards democracy and capitalism took further root. The onward march of capitalism and democracy however was halted during the inter-war period.

Keywords: capitalism, democracy, economic growth, industrial revolution, development

1. Introduction

The term development encompasses a whole range of changes in society. In a strict economic sense, development is sustained increase in output per person over a period of time inclusive of occupational and structural changes in the economy. In a broader sense however it also includes changes in social mobilization and political institutions. Development therefore is a multifaceted phenomenon. Sustained economic growth has important social and political consequences. In the Malthusian world sustained economic growth is hard to come by. The roots of modern development are traced to the onset of the industrial revolution. It brought in its train *modern economic growth*. The European economy witnessed pre-industrial development between 1500 and 1750 that laid the foundational roots of the development of capitalism in the future. Once sustained economic growth picked up steam, it produced far reaching social and political consequences. A key development was the division of labour and specialization become more refined with the improvement of production technology. It further inspired social mobilization and clamour for political change. Political reforms and change were not easy to come. The rising income levels and spread of development brought a significant change in mobility, social consciousness and a demand for political participation and equality. Liberal democracy however emerged over the successive generations. The nineteenth century was a period of major convulsions in the European society. The first wave of democratization was protracted. The gains made over the previous decades were lost during the interwar years when collectivist philosophies and the appeal of a welfare state acquired credence. Capitalism and liberal democracy were on the back foot.

2. Industrial Revolution, Economic Growth and the birth of Modern Capitalism

Where did modern economic growth come from? What makes economies grow over a period of time? Why do economists care so much about economic growth? These are some of the most fascinating economic questions of our time. For much of the human history societies were either stagnant or changed only slowly. They were stuck in the *Malthusian Trap*, named after Reverend Thomas Robert Malthus who suggested that humankind was trapped at the intersection of two laws. The first concerned the rate at which population could grow and the second with the growth of food and other resources. Under conditions of 'natural' fertility (with early marriage and no contraception, abortion or infanticide), population, posited Malthus, would grow at a geometrical pace while given the limitations of the agrarian economy and the law of diminishing marginal return, food and other resources would witness a linear or arithmetic growth.[1] The basic idea being that population tends to grow exponentially while the means of subsistence only linearly or arithmetically. At some point food intake per capita shrinks with tragic effects.[2] There could therefore be *no sustained economic growth* in such a Malthusian economy characterized by primitive production technology. However, the decades preceding the Industrial Revolution were transformative for the European economy. It prepared the ground for the coming change.

The industrial revolution was the capstone of the economic transformation that took place in the European economy between 1500 and 1750. During the beginning of this period most Europeans lived in backward regions. Agriculture was the mainstay of the economy. *About three-quarters of the people were agricultural in England, Austria-Hungary, Germany, France and Poland.* The non-agricultural economy was small; urbanization was low. Production took place in workshops or in home. *The reconfiguration of the European economy* was precipitated by greater market integration and expansion of trade. The leading economies of Europe in 1500 were Italy, Spain and present-day Belgium. The Dutch economy was the most advanced in the seventeenth century. Intercontinental trade became more prominent in seventeenth and eighteenth centuries. Portugal and Netherlands were successful in establishing colonies. The city of Amsterdam rose to economic prominence during this period. It was however taken over by London in the following decades due to the vigorous colonial policy, navigations acts and successful wars with the Dutch. From here on international trade became increasingly important to the British contributing to the rise of the cities. Larger cities in turn sustained a more refined division of labour. The expansion of the pre-industrial economy was underpinned by favorable cultural and institutional changes that fueled capitalist development and industrial revolution.[3]

It was after the industrial revolution that growth picked up momentum and economic life stared getting better. The quality of life in many regions of the world was poor by today's standards. Life expectancy was low due to the frequent visitation of plagues, diseases and famines. The bubonic plague also known as the Black Death for instance killed millions during the Midde Ages. The noted economist Angus Deaton points out that it was the introduction of antibiotics, pest controls, vaccinations and clean drinking water that substantially improved the health and well-being of societies in the decades that followed.[4] The industrial revolution *changed forever the possibilities of human comfort.*[5] What accelerated this

[1] Alan McFarlane 2005
[2] Jorg Friedrichs 2019
[3] Robert Allen 2009 Ch 1 pp 1-22
[4] Angus Deaton 2013
[5] Gregory Clark 2007

transformation in human situation was the rapid technological advancement that characterizes this period. The key technologies of the Industrial Revolution were application of steam power to a wide array of *uses*, the substitution of iron for wood, move away from home and workshops to the factory system of production, and mechanization of production. These innovations were interrelated in their application. Steam engines unlocked power stored in coal, iron was used in the making of industrial machinery and transportation.[6]

The economists and historians have long pondered over the causes of the industrial revolution. Joel Mokyr (2009) attributes the inventiveness of the industrial revolution to scientific Revolution and the Enlightenment. In eighteenth century, an intellectual movement – *Enlightenment* - that advocated reason as the source of authority and legitimacy dominated the intellectual discourse in Britain and northwestern Europe. The enlightenment did not originate in Britain but elsewhere in Europe. It however had a significant influence in the intellectual and cultural life of Britain. The enlightenment movement consisted of three projects: political, philosophical and economic. Of the three, a lot of emphasis has been placed of the first two. The third, suggests Joel Mokyr, was of far greater importance. It put emphasis on wealth creation and increasing well-being.[7] Adam Smith's magnum opus Wealth of Nations published in 1776 was an '*inquiry*' into the '*causes*' of material prosperity. He declared that '*it is the great multiplication of the productions of all the different arts, in consequence of the division of labour, which occasions, in a well-governed society that universal opulence which extends itself to the lowest ranks of the people.*'[8] The French philosopher and political economist Marquis de Condorcet and the English philosopher and psychologist David Hartley pushed the idea of progress and believed that individuals and institutions were improvable. The English and the Scottish enlightenment expressed deep commitment to economic progress through political economy and application of reason and knowledge.[9]

Mokyr points out that the *Industrial Enlightenment* was that part of the enlightenment that believed that material progress was possible through increasing human knowledge of the natural phenomenon and application of scientific ideas to production. It had four aspects: first, beyond the major inventions and the inventors there were many second-and-third tier inventors who contributed to increasing efficiency of the production process; second, there was a network of inventors, producers, scientists that exchanged ideas at scientific societies. The *Royal Society* was one such platform that came into existence in 1660. The third aspect was the application of the scientific method to the study of technology through *experimentation*. The fourth aspect of the industrial enlightenment was its *class aspect*. It was not a mass-phenomenon. It did not come from below. *It was a minority affair confined to a fairly thin silver of highly trained and literate men.*[10]

The western European countries took lead in embracing modern ideas and institution that fueled their economic growth and spread prosperity in the decades that followed. The industrial revolution did not peter out after the initial burst of productivity gains. It translated into *Modern Economic Growth.* Technological improvement was certainly at the heart of this transformative economic change. It however also fueled changes that reinforced each other and created a world of economic possibilities. Machinery

[6] Joshua L Rosenbloom 2025
[7] Joel Mokyr 2009 pp 30
[8] Adam Smith 1999 pp 115
[9] Joel Mokyr 2009 Ch. 2 pp. 37
[10] Robert Allen 2009 Ch. 10 238-242

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production fueled three developments that explain the continuation of economic growth until the First World War. (1) the general mechanization of industry (2) the railroads (3) stem-powered iron-ships.[11] Ever since there has been a sustained increase in incomes and rising living standards that was unimaginable a few centuries earlier. It is a *durable* achievement of modern times.[12] Europe was no longer a stagnant society where change occurred at glacial pace. It was on the move. 'The industrial revolution was neither the age of steam nor the age of cotton, nor the age of iron. It was the *age of progress*;' noted Deirde McCloskey.[13]

The technological innovations opened up new possibilities not just in economics but in other areas as well. In the centuries leading up to the industrial revolution education was confined to the privileged sections of the society. The invention of the printing press increased the spread of literacy however education to serve the economic purpose was perhaps still in its infancy. Even during the earlier phases of the industrial revolution, literacy did not gather momentum as it found limited use in the production process. In the later phases however the process of industrialization and economic development emphasized the need for skills, training and technical know-how and of mass education.[14]

The sustained economic growth brought in its train far reaching social and political changes. So consequential were the changes that writing in 1848, Marx and Engles, predicted a class war between the workers and the capitalists that would ultimately lead to the fall of capitalism.[15] Such a catastrophic prediction about the demise of capitalism though *never* occurred. Plausibly, political reforms, extension of franchise, enlightenment and changing social values all in some important ways coalesced to mitigate the revolutionary pressures in the society. In fact, many of these reforms were initiated to thwart the revolutionary tendencies in the nineteenth century.[16] It need not be overemphasized that industrial revolution and modern economic growth had been transformative for the society.

3. Adam Smith, Division of Labour and the roots of modern Democracy

How transformative were the effect of modern economic growth on the development of political institutions? The Stanford political scientist Francis Fukuyama grapples with this important question in his two-volume magisterial work – *The Origins of Political Order: From Prehuman Times to the French Revolution* and, *Political Order and Political Decay: From the Industrial Revolution to the Globalization of Democracy.* He notes, 'once the Industrial Revolution occurred and human societies exited Malthusian conditions they had experienced up to then, a new dynamic was added to the process of social change that would have huge political consequences.' He contends that 'a sudden shift to a higher level of growth had a huge effect on societies via an expanding division of labor.' But how does economic growth engender political change? He notes that 'social mobilization creates political change by creating new groups that demand participation in the political system.'[17]

[11] Ibid. pp 273
[12] Sebastian Conrad and Jurgen Osterhammel 2018 pp 277
[13] Quoted by Oded Galor 2022 pp 58
[14] Oded Galor 2022 Ch. 4 pp 63-73
[15] Marx and Engels 2015
[16] Daron Acemoglu and James Robinson 2000
[17] Francis Fukuyama 2015 pp 44-47

Adam Smith, a major figure of economics and the Scottish enlightenment, inquired into the nature and cause of economic opulence in his book, *Wealth of Nations,* first published in March 1776. He ponders on the causes of economic well-being and prosperity of societies. One of his important contributions has been to place division of labour as a key explanatory factor as a cause of Both labour and capital are they key factors of production. The productivity of labour is an important determinant of the economic growth. The proposition Adam Smith put forward was simple: an important source of the improvement in the productivity of labour was the application of division of labour in the production process. When a complex production process (various steps associated with final production of a commodity) was split into various parts and each worker was asked to perform one part, this would promote specialization and enhance productivity.

Smith gave three reasons for this improvement: increase in dexterity in every particular workman; second, saving of the time which is commonly lost in passing from one species of work to another; and; lastly application of machines that make the labour more productive. He cites the example of the trade of a pin-maker to illustrate this point. He further adds that such a division of labour was possible where the market for commodities was large. He famously wrote that the division of labour was limited by the extent of the market. The societies with minimal economic progress were often the ones where the occasion for division of labour was limited or in a stage of infancy. In *improved societies,* or the societies that enjoy the 'highest degree of industry and improvement' the division of labour is carried to the furthest, that is, they are characterized by higher degree of specialization. The woolen-coat for instance is the joint produce of many workers – the shepherd, the sorter of the wool, the wool-comber or the carder, the dyer, the scribbler, the spinner, the weaver, the fuller, and the dresser! A variety of labour is necessary to produce the final product.

The industrial revolution accelerated this process of division of labour in the society. Smith writes that *it is the multiplication of the production* (read economic growth*) of all the different arts, in consequence of the division of labor, which occasions in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people.*[18] The industrial revolution or accelerated economic change was not without its consequential impact on the politics and society. It disturbed the equilibrium of the pre-industrial societies. Sustained economic growth sped up social change by driving new forms of social mobilization, creating new actors who saw the society differently and asked for greater political participation.[19] The industrial revolution created new classes of people – the urban working class and the entrepreneurial capitalist class. Karl Marx labelled this binary classification the *proletariat* and *bourgeoise* respectively.[20] These classes were many decades in the making. The English historian E P Thompson concluded that *the working class did not rise like the sun at the appointed time. It was present at its own making.*[21]

Friedrich Engels, author and sociologist, produced *The Condition of the Working Class in England* in 1844 where he highlighted the challenges faced by the workers living in the backstreet sections of Manchester. By the late 1880s Engels however noted that there was improvement in the living standards.[22] Over the previous couple of decades many reforms had been introduced however democracy and the welfare state

[18] Adam Smith 1999 pp 109-126
[19] Francis Fukuyama 2015 Ch. 2 pp. 45
[20] Karl Marx and Friedrich Engels 2015
[21] E P Thompson 1980 pp 7
[22] Friedrich Engels 2009

as we know it today were nowhere to be seen. Fukuyama concludes that Europe was not *socially ready* for democracy until the final third of the nineteenth century. The European route to democracy unfolded in stages over a period of 150 years growing out from the struggle among the ruling oligarchy, middle class, urban working class and the peasantry.[23]The phrase '*Waves of Democratization'* was coined by Samuel Huntington in the 1990s to describe the global trend towards democratization.[24] The First Wave of Democratization was protracted. The French Revolution, the American War of Independence, the European Revolutions of 1848 all signified a deep urge for liberty and political equality. The decades after 1848 turned out to be economically and socially transformative for European societies giving further strength to the democratic impulse.

World War I delivered a fatal blow to the monarchies and autocratic regimes across Europe giving birth to parliamentary democracies. This triumphalism however proved to be short-lived when during the interwar period the *Great Depression* fueled social unrest and political conflict giving birth to dictatorships and authoritarian regimes. It is worth remembering here that the entry of America in the First World War had among its noble aims the promotion of democracy and of freedom. President Woodrow Wilson's '*Fourteen Points*' speech championing self-determination in part laid the groundwork for an ideological attack on colonialism and imperialism. If the First World War dealt a blow to the monarchies, the Second World War dealt a serious blow to the European colonial powers who in the subsequent decolonization movements lost their empires across Asia and Africa. This paved the way for the birth of new democracies.

4. Capitalism and Socialism during the mid-20th Century

The postwar period saw the emergence of new nations, new hopes and a renewed commitment to build a peaceful international order that fostered economic cooperation and political stability. The interwar experience of nations had not been good. The rise of dictatorships challenged values of democracy and freedom while the Great Depression and the tariff war that brought economic hardships to many raised questions on the efficacy of the capitalist economic system. The success of the New Deal in fighting the Great Depression, the speedy economic achievements of Russia, and the faith in socialism and economic planning fueled the rise of the welfare state in the 1950s. In England, the Labour Party under the leadership of Clement Attlee, registered a massive victory at the elections held in 1945 that shifted the ideological discourse towards socialism, nationalization and state control of the economy.

Joseph Schummpeter, the Austrian-born Harvad based economist who coined the popular phrase 'creative destruction' in his book Capitalism, Socialism and Democracy (1942) declared that socialism would prevail upon capitalism. In his book he tried to answer two historically relevant questions: Can Capitalism survive? And that, Can Socialism work? To the first question, his answer was a No, while he emphatically affirmed the workability and success of socialism. The popular sentiment, he argued, was averse to capitalism and the capitalist class, and the public had found sympathy with anti-capitalist interests.[25] So widespread seems to be the appeal of socialist thought that even Paul Samuelson, a notable economist, wrote in his influential textbook *Economics* that a socialist command economy could function and thrive,

[23] Francis Fukuyama 2015 chapters 27-30
[24] Samuel Huntington 1991
[25] Joseph Schumpeter 1942 Ch V, XV

and further went on to predict that in the coming decades the gross national product of the Soviet economy could outperform that of the United States.[26]

Even though the voices of collectivist socialist philosophy were ascendent there were many influential voices whose faith in liberty and capitalism remained undiminished. Frederich Von Hayek, the Austria born accomplished British economist and philosopher, produced two important pieces of writing in the 1940s: a short but a hugely influential book *The Road to Serfdom* in 1944; and a scholarly article *The Use of Knowledge in Society* in the American Economic Review in 1945. In 1943 Fritz Machulp, a friend of Hayek, showed a typescript of *The Road to Serfdom* to Aron Director, who passed it to economist Frank Knight in Chicago. Despite Knight's skeptical report, the University of Chicago agreed to publish it. The book went to sell hundreds of copies[27]! The *Road to Serfdom* was a masterly work of a high intellectual value that systematically refuted the collectivist socialist philosophy and economic planning, which Hayek believed ran counter to the economic logic of capitalism and democracy. He quoted the French scholar de Tocqueville who concluded that democracy and socialism were irreconcilable. Democracy and socialism had nothing in common except one world: equality. While democracy sought equality in liberty, socialism sought equality in restraint and servitude.[28]

Socialism lent itself into two different kinds of meanings: in the first sense it was used to describe a certain *end* like greater equality and social justice while in the second sense it denotes the *means* the important feature being the abolition of private enterprise, of private ownership of means of production and the creation of a system of a planned economy driven not by hundreds of entrepreneurs but a central planning authority.[29]

Hayek was more concerned with the latter definition which he thought was unworkable. Those who championed the cause of economic planning desired a *central control* and direction of the economic activities of the society to better serve certain laudable goals. Contrary to the popular notion, Hayek was not opposed to economic planning per se. He was however critical of the idea of a central authority planning for the entire economy which he thought was unworkable. He accepts that we need to employ *foresight and systematic thinking* in planning our common affairs. But what was the *best way of so doing*? That, he contends is the dispute. There are two options. The holder of the coercive power (read the state) can create the conditions where the knowledge and initiative of individuals is given the best scope for planning; in the second case, a rational utilization of resources require *central direction* and a consciously designed blueprint to organize the affairs of the economy. It was in the latter sense that economic planning was viewed by the socialists.[30]

It is worth recalling here that the economic and political success of western European nations, and that of the United States later, that had emerged as the beacon of Capitalism and Democracy, were bult around application of what eminent historian Niall Ferguson has called the *Six Killer Apps.* These six institutions and ideas peculiar to the western civilization were the driving factors in building its global domination: Competition; science; property rights; medicine; consumption; work. These social developments forged

[26] Niall Ferguson 2023
[27] Nicholas Wapshott 2012 pp 247
[28] Hayek 1944 pp 25
[29] Ibid 33-34
[30] Ibid pp 36-37

the western civilization ahead of the East.[31] A key factor had been the successful use of the *principle of competition* for resource allocation and social organization. Hayek pointed out that instead of command and control from the centre the forces of competition were better at coordinating human activities and produced beneficial outcomes. He did not champion a laissez-faire system where everything was left to the market forces. He says: *the functioning of competition not only requires adequate organization of certain institutions like money, markets, and channels of information – some of which can never provided by the private enterprise – but it depends above all on the existence of an appropriate legal system, a legal system designed both to preserve competition and make it operate as beneficially as possible.*[32]

But what if we tried to combine competition with central direction? Was it feasible? Would it be efficient? Hayek says, No. These are alternative principles used to solve the same problem, and a mixture of the two will mean that neither will work efficiently. *Planning and competition can be combined only by planning for competition, but not by planning against competition.*[33] Why then around the midcentury do we find an admiration for socialism and economic planning? Probably the intellectual appeal came from its vocal advocacy to create a more just and equal society. Second, the followers truly believed in the feasibility of the central planning, the instrument that would create a fairer society by better use of existing resources and manpower. The success of economic planning in Soviet Russia was far too important an inspiration. Third, capitalism had come under severe stress during the interwar period due to the Great Depression. Capitalism had produced phenomenal economic success in the past however in the eyes of its critics it remained unstable, unequal and unjust. Four, New Deal policies in the United States were grounded in the view that government ought to play a more active role in the economy to fight economic downturns and restore growth and employment. Five, the socialist and the communist movements were international in character and had followers in many countries. They had been gathering pace since the 19th century. Lastly, in the Marxist schema, argues Schumpeter, private control over the means of production was seen as providing the capitalist class with the power to exploit labor and also an ability to impose the dictates of its class interest. The political power of the capitalist class was thus a special form of economic power.[34] By opposing the private ownership of means of production, the socialists were actually arguing to reduce the economic and political power of the capitalists probably oblivious of the fact that too much power in the hands of politicians and the bureaucrats in the name of socialism was not a good thing either.

5. Conclusion

In conclusion, sustained development is a recent phenomenon. The world we see around has been the miraculous achievement of the past three centuries. The pre-industrial economy was characterized by tepid growth where the production technology was primitive. *Second,* the industrial revolution was driven by technological advancements that created modern economic growth. It had far-reaching social and political consequences. *Three,* in the decades that followed changes in social mobilization and further refinement of division of labour and specialization engendered political reforms. *Four*, capitalism and democratization gained momentum in the second-half of the nineteenth century however during the inter-

[31] Niall Ferguson 2011
[32] Hayek 1944 pp 39
[33] Ibid pp 43
[34] Joseph Schumpeter 1944 pp 235

war years it hit a roadblock. Finally, by the end of the Second World War socialism and welfare state were ascendent. It became fashionable to be labeled a democratic socialist.

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