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THE PHYSICRATS: FRIENDS OR FOES OF LIBERTY?

BRADLEY K. HOBB$^{1}$ AND NIKOLAI G. WENZEL$^{2}$

ABSTRACT

Were the Physiocrats friends or foes of liberty? Some classical liberal economists hail the Physiocrats as precursors of modern liberty, while others decry them for planting the seeds of mathematical economics and interventionism. Smith and Rothbard praise the Physiocrats, while Hayek, Roepke and Tocqueville damn them. While we focus on classical liberal interpretations of the Physiocrats, we also return to the secondary literature – but also to the writings of François Quesnay, founder of Physiocracy. We find a mixed bag, and both strains of classical liberalism are partially correct. The Physiocrats were early proponents of natural law, individual rights, and free trade. They also planted the roots of modern economic interventionism.

KEYWORDS

Physiocrats, Quesnay, Hayek, Roepke, Smith, Rothbard

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1. INTRODUCTION

The 18th century Physiocratic school is uncontroversially considered to be a precursor to classical economics, and to have had a profound impact on French society leading to the Revolution of 1789. The Physiocrats are generally considered to be friends of liberty. Adam Smith was inspired by them; the 19th century classical liberal “Economistes” (Frédéric Bastiat, Jean-Baptiste Say, etc.) considered them to be heroes; Murray Rothbard deemed them to be precursors to the Austrian School.

However, several important voices in the classical liberal tradition of liberty disagree, often strongly. F.A. Hayek lumps the Physiocrats in with the Cartesian or “rational constructivist” French enlightenment he so despised for its pernicious effects on politics, economics and society. Fellow Mont Pèlerin Society founding member and Austrian economist Wilhelm Roepke sees the Physiocrats as precursors to modern interventionist “economic engineers.” Walter Bagehot, founding editor of the Economist, and the great Alexis de Tocqueville both disliked the school. Meek (1963, 27) goes so far as to describe the Physiocrats as “odd” precursors to Marx. He also notes the ideological fervor among the followers of the Physiocrats, citing Schumpeter’s contention that their fervor matched “the fidelity of the orthodox Marxists to the message of Marx and the fidelity of orthodox Keynesians to the message of Keynes.”

Were Hayek and Tocqueville wrong? Were Smith and Say? Or is there perhaps a nuanced reading to determine why each camp formed? We argue that there were two main lessons that subsequent scholars drew from the Physiocrats that ultimately help us to understand the conflicting interpretations. First, the Physiocrats used a mathematized, formal analysis of an economy where agriculture must prevail; second, their work was also infused with reference and homage to natural law, respect for private property, free trade, and sound taxation policies. Whereas the first strain may be read as a precursor to Walrasian general equilibrium and the advent of economic engineering, the second strain surely sounds like Adam Smith’s recipe for prosperity contained in the simple directions of “peace, easy taxes, and a tolerable administration of justice” (Smith 1982[1755]). It is thus quite plausible that the judgment of Physiocratic contributions will vary depending upon one’s reading of their works.

Section One reviews the modern debunkers of the Physiocrats within the classical liberal tradition. Section Two reviews the modern admirers of the School, also within that tradition. Section Three goes back to the source, with a summary of the main precepts of the Physiocrats, which is then broken down into two sections, the good and the bad, political economy versus economic engineering – or, in a synecdoche of sorts, Smith versus Walras. The final section reviews the evidence, assesses and concludes.

3 We define liberty simply, in the classical liberal sense of economic freedom and political autonomy.
2. THE PHYSIOCRATS: FOES OF LIBERTY

The two principal modern detractors of Physiocracy, from the classical liberal perspective, are Hayek and Roepke.

In his writings on political economy, Hayek was primarily concerned with the knowledge problem – the puzzle of economic organization, in light of the fact that knowledge is diffuse and tacitly held throughout society, in the minds of individual market actors, rather than centrally and collectively. He suggested that various institutions, from the price mechanism to societal norms, compensate for the knowledge problem by allowing for the creation and transmission of knowledge (see, especially Hayek 1945 and Hayek 1960). To overcome the knowledge problem effectively, we must rely on spontaneous order and emergent institutions, rather than attempting to design institutions based on limited knowledge. Hayek’s intellectual bête noire was thus the Cartesian legacy of “rationalist constructivism.” Hayek viewed the attempt to engineer and impose institutions from the top down as an “abuse of reason” (Hayek 1979[1952]) that was destructive to true, emergent individualism (as opposed to the false, imposed individualism of rational constructivism) (see also Hayek 1948).

While the first strand of individualism includes early thinkers like Locke, Mandeville, and Hume and later ones including Tucker, Ferguson, Smith and Hume, the “second and altogether different strand of thought, also known as individualism, is represented mainly by French and other Continental writers – a fact due... to the dominant role which Cartesian rationalism plays in its composition. The outstanding representatives of this tradition are the Encyclopedists, Rousseau and the physiocrats.” Hayek goes further, stating that “this rationalistic individualism always tends to develop into the opposite of individualism, namely, socialism or collectivism” (Hayek 1948, 4). He continues with his historical analysis of “scientism” (the attempt to apply the rules of the natural sciences to the social sciences, through social and economic engineering): “the attempts to treat social phenomena ‘scientistically,’ which became so influential in the 19th century, were not completely absent in the 18th. There is at least a strong element of it in the work of Montesquieu and the Physiocrats (Hayek 1979[1952], 19, n.1).” Hayek continues, in his assessment of François Quesnay, founder of the Physiocrats, claiming that he was part of the “older rationalist views of society, which regarded it as a conscious creation of man” (Hayek 1979[1952], 189-190, n. 6). Hayek distinguishes between the rationalist constructivism of the physiocrats and the emergent order of Smith et seq.: “One might indeed trace much of the contrast [between Adam Smith’s understanding of the market mechanism and] the rationalistic-pragmatic interpretation of social phenomena, which with Saint-Simon and Comte became an open opposition to classical economics, back to the differences which existed, say, between Montesquieu and Hume, Quesnay and Smith, or Condorcet and Bentham” (Hayek 1979[1952], 189, n. 6). In contrast to other thinkers who saw a substantial thread from the Physiocrats to Adam Smith, Hayek complains that “the common habit of lumping Adam Smith and Quesnay together, caused by the former belief that Smith was greatly indebted to the physiocrats, should certainly cease” (Hayek 1948, 12, n. 2).
Wilhelm Roepke echoes some of these differences, although he appears to be more concerned with the 20th-century phenomenon of mathematical hegemony in economics, rather than the more general problem of rationalist constructivism: “The prototype of the modern economocrat is the 18th-century physiocrat. The physiocrats – or économistes, led by Quesnay – are clearly the ancestors of all the power-thirsty, cocksure, and arrogant planners and organizers” (Roepke 1998[1960], 238, n. 34 to chapter III). Roepke continues by citing other friends of liberty who disparage the Physiocrats (*ibid*):

Walter Bagehot (*Biographical Studies* [London, 1881], 269f.) paints a vivid picture of them. He says that a contemporary of Quesnay’s wrote of him that he was convinced that he had reduced economic theory to a mere calculation and to axioms of irrefutable evidence. Tocqueville (*L'Ancien Régime et la Révolution* [1856], chapter 3) says of the physiocrats: “They not only abhor certain privileges, but all diversity: they would worship equality even if it meant general slavery. Whatever does not fit in with their designs has to be smashed. They have little respect for contracts and none for private rights; or rather, they do not, strictly speaking, admit private rights at all, but only the common benefit.

In sum, two luminaries of 20th-century classical liberal thought - Hayek and Roepke - paint a rather damning picture of the Physiocrats as rational-constructivists, proto-Walrasian, proto-Samuelsonian mathematicians who willingly and gladly impose their technocratic wisdoms on the world. In their view, the Physiocrats were scoundrels who planted the seeds of subsequent attempts to micromanage the extended order of the market. Hayek, Roepke, Bagehot and Tocqueville provide a marked contrast to those who view the physiocrats as early advocates of the free society.

### 3. THE PHYSIOCRATS: FRIENDS OF LIBERTY

Adam Smith, a contemporary of the Physiocrats, refers to their work as “[a] very ingenious system” which “at present exists only in the speculations of a few men of great learning and ingenuity in France.” (Smith, [1981]1776, 663). He lays heavy praise upon the Physiocrats.

This system, however, with all its imperfections is, perhaps, the nearest approximation to the truth that has yet been published upon the subject of political economy, and is upon that account well worth the consideration of every man who wishes to examine with attention the principles of that very important science. Though in representing the labor which is employed upon land is the only productive labor, the notions which it inculcates are perhaps too narrow and confined; yet in representing the wealth of nations as consisting, not in the unconsumed mobile riches of money, but in the consumable goods annually reproduced by the labor of
the society; and in representing perfect liberty is the only effectual expedient for rendering this annual reproduction the greatest possible, its doctrine seems to be in every respect as just as it is generous and liberal. (ibid, 678).

Smith’s primary support seems to be rooted in the Physiocrats commitment to perfect liberty and natural rights. Other evidence indicates that Smith may have been drawn to the Physiocrats by their support for natural rights and liberty. We turn to the work of Albaum (1955); although Albaum is not a classical liberal, and is ultimately quite critical of the Physiocrats based upon his Marxist lens, he makes a solid case for the commitment of the school to natural rights, liberty, and individualism. Albaum (1955, 1979) notes that one of the last Physiocrats, DuPont de Nemours, in letter correspondence with J.B. Say, defended the Physiocrats by claiming their work to be firmly rooted in “the science of natural right, applied as it ought to be, to civilized societies.” Albaum claims that the fundamental foundation of physiocratic thought was property: “The liberty the Physiocrats were talking about was individual liberty and the property was private property.” (ibid, 186). Albaum (ibid, 190) explains: “we know that the individual is a vague protean mass and less he is defined by his social relationships. When the Physiocrats tried to judge these relationships by individual needs, they were merely making the individual a capsule of their assumptions about social institutions. This was the function of their ethical individualism…. Like much of their theory of property, the Physiocrats’ social naturalism derived from the opening chapters of Locke’s Second Treatise on Civil Government.”

Murray Rothbard, the standard bearer for the hard core of free-market Austrian economics, has mostly kind words for the Physiocrats. They “were among the first laissez-faire thinkers, casting aside contemptuously the entire mercantilist baggage” (Rothbard 2006[1995], 367), calling for mostly unfettered internal and external trade. They “were the first economists to stress and develop the case for laissez-faire” (ibid, 368). Rothbard (ibid, 369), himself a natural rights theorist, has particularly kind words for Quesnay:

Not only were the physiocrats generally consistent advocates of laissez-faire, but they also supported the operation of a free market and the natural rights of person and property. John Locke and the Levellers in England had transformed the rather vague and holistic notions of natural law into the clear-cut, firmly individualistic concepts of the natural rights of every human being. But the physiocrats were the first to apply natural rights and property rights concepts fully to the free market economy. In a sense, they completed the work of Locke and brought full Lockeanism to economics.

And in applied terms, his recommendation is rather glowing (ibid, 371)

The dauphin of France once complained to Quesnay of the difficulty of being a king, and the physician replied that it was really quite simple. “What then”, asked the dauphin, “would you do if you were king?” “Nothing”, was the straightforward,
stark, and magnificently libertarian answer of Dr Quesnay. “But then who would govern?” sputtered the dauphin? “The law”, that is, the natural law, was Quesnay’s accurate but no doubt unsatisfying reply.

Although he disparages the technical economics of the Physiocrats (as we will see below), Rothbard (ibid, 374) concludes that “the physiocrats had useful insights into political economy and the importance of the free market.”

4. BACK TO THE SOURCE: STRAIGHT FROM THE HORSE’S MOUTH

Before we can solve the puzzle of conflicting interpretations about the Physiocrats, we must study the original writings of the School. We focus here on the writings of François Quesnay – first, because he is widely considered to be the school’s founder; and second, because of the general scholarly consensus, reflected in the following assessment from the 1853 Dictionary of Political Economy: “the philosophical ideas of the [Physiocratic] School are spread out among different writings by the master [(Quesnay)] and his disciples; but they are mostly confined to a small treatise by Quesnay on natural law, and summarized in his fragments, published under the title of Maxims” (Coquelin and Guillaumin 1853, 362, translation our own).

As a reminder, the Greek roots of “physiocrat” are phýsis (nature) and krátos (power), an etymology which transpires into the school’s main precepts (see Henderson 2008). Here, we draw on Quesnay’s two principal works: (1) his essay “On Natural Law,” and (2) his “General Maxims for the Economic Government of an Agricultural Kingdom”, to summarize physiocratic thought on natural law and economic governance.

4.1. “ON NATURAL LAW”

Dupont de Nemours, a publicizer and student of Quesnay, wrote in 1767 that “natural law was the lynchpin for [Quesnay’s] entire structure” (Cartelier 1991b, 47, translation our own). It is thus fitting to begin here.

Quesnay himself summarizes his vision of natural law as follows (for this and subsequent quotations from Quesnay, we draw from Cartelier 1991a):

- “Natural law differs from positive law, which is decreed by human authorities” (72);
- “positive law often restricts natural law, because human laws are not as perfect as the laws of the Author of reason” (72); positive laws are decreed for natural law to be

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4 As a sidenote, Fox-Genovese (1976, 14) challenges the prevalent view, started by Physiocratic publicist Pierre Samuel Dupont de Nemours, of Quesnay as teacher, and Mirabeau as student, viewing them instead as co-founders. We adhere here to the mainstream view.
observed (85); “the first positive law, the fundamental law... is the institution of public and private instruction of the laws of the natural order” (84);

- Natural law boils down to “the portion that [each man] can obtain through his work” (73); “each person has the natural right to use... all the faculties that were given to him by nature, in the circumstances where it has placed him, under the condition that he not harm himself or others” (78); justice is “a natural and sovereign rule, recognized by the lights of reason, that determines obviously what belongs to oneself, or to another” (71)

- “Reason alone is insufficient... for man to conduct himself; he must also acquire through reason the knowledge that is necessary to him, and through his reason he must use his knowledge to conduct himself properly, and to obtain the goods he needs” (85)

- “Positive laws can stray from the permanent laws of justice, and the natural order that is most advantageous to society” (72); “natural law [means following] the best possible laws that constitute the order that is most advantageous for men gathered together in society” (85); “laws do not restrict individual liberty, which is part of natural law... Man cannot reasonably refuse to obey [natural] law, otherwise his freedom would be detrimental to himself and others; it would be the liberty of a madman, which, under good government, must be contained and corrected by the authority of positive laws in society” (86).

Meek, quoting from Quesnay (1963, 45) offers two further clarifications:

- Natural right differs from legal right (the latter, being “conferred by human laws”) “in that it is self-evidently recognized through the light of reason, and through this self-evident character alone is binding independently of any coercion...”

- Natural law precedes, and will ultimately subsume, positive law, given the primacy of natural law. However, we live with contradictions because “the host of contradictory and absurd laws which nations have successively adopted proves clearly that positive laws are often apt to deviate from the immutable rules of justice and of the natural order which is most advantageous to society.”

4.2. “GENERAL MAXIMS FOR THE ECONOMIC GOVERNMENT OF AN AGRICULTURAL KINGDOM”

Quesnay summarizes his economic teachings in his “General Maxims.” These number thirty, which we cite here in summary form:

I. Unity of state authority over individual interests (marked by support for the monarchy to advance the interests of the only wealth-producing sector, agriculture).

II. Let the Nation be instructed as to General Natural Laws, which make a government more perfect (aimed at attaining prosperity for society).

III. Land and agriculture are the sole source of riches.

IV. Protection of private property is the essential foundation of economic order (with the role of the sovereign central, for “it is only the sovereign power which guarantees the property of its subjects”).
V. Reasonable taxes (applied to “the net product of landed property, and not on men’s wages, or on produce... [which would] destroy every year a portion of the nation’s wealth”).

VI. Investment in agriculture (“to ensure the production of taxes, revenue, and subsistence for all classes of citizens”).

VII. and XXVIII. Investment is to be favored over the accumulation of wealth.

VII.I and IX. Favor productive expenditures (agricultural) over sterile expenditures (commerce/industry).

X. and XXIV. Avoid trade imbalances.

XI. Avoid brain drain and capital flight.

XII. Maintain population and wealth in the countryside to encourage agriculture.

XIII. Freedom of cultivation, while encouraging comparative advantage.

XIV. and XV. Favor multiplication of cattle for fertilizer and economies of scale in grain production.

XVI. and XXV. Free trade.

XVII. Encourage marketing and transportation of produce through the provision of infrastructure.

XVIII. “Good” prices for agricultural products and merchandise.

XIX. and XX. Low prices are harmful to the people; favor comfort for the lowest classes of citizens.

XXI.–XXIII. Favor investment and trade in agriculture (over industry/commerce); discourage luxury; encourage agricultural and subsistence consumption.

XXVI. Favor tax revenue over population growth.

XXVII. Favor necessary public expenditures over budget surpluses.

XXIX. and XXX. Beware financiers and avoid state debt.

4.3. ASSESSING THE PHYSIOCRATS FROM A CLASSICAL LIBERAL PERSPECTIVE (1): THE GOOD

Quesnay’s take on the natural law fits neatly in the classical liberal tradition. Indeed, he invokes an authority greater than any human authority, whether absolute monarch or democratic legislature, in a simultaneous stick in the eye to the absolutism of Louis XIV and the later positivism of Auguste Comte and Hans Kelsen later (see Hayek 1973, 1976, 1979 and 1979[1952]). Quesnay’s distinction between law and legislation (or, in his language, natural law versus positive law) is reminiscent of Hayek at his finest hour (see Hayek 1973, 1976 and 1979, as well as de Jouvenel 1993[1945], for a similar distinction between discovered natural law and engineered legislation). For Quesnay, “only rules emanating from an authority superior to men can preserve society from the abuses of tyranny” (Cartelier 1991b, 17).

What is more, the central position and inviolability of private property (Maxim IV) clearly falls in line with Hayek’s description of the rule of law (see Hayek 1960) and more modern manifestations from the New Institutional Economics (see Furubotn and Richter 2000). For Quesnay, private property rights are a foundation for good government (Cartelier
Though the earth, and all inferior creatures, be common to all men, yet every man has a property in his own person: this nobody has any right to but himself. The labour of his body, and the work of his hands, we may say, are properly his. Whatesoever then he removes out of the state that nature hath provided, and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property. It being by him removed from the common state nature hath placed it in, it hath by this labour something annexed to it, that excludes the common right of other men: for this labour being the unquestionable property of the labourer, no man but he can have a right to what that is once joined to, at least where there is enough, and as good, left in common for others.

Quesnay himself states in *Natural Right* (Chapter II: The Extent of the Natural Right of Man; see Meek 1963, 46):

In the state of pure nature, nothing suitable for man to use are reduced to those which nature produces spontaneously and over which each man can exercise is indeterminate natural right only by procuring for himself a shirt and share through his labor, i.e., through his endeavors. Whence it follows: (1) that his right to everything is only ideal; (2) that the share of things which he enjoys in the state of pure nature is obtained through labour; (3) that his right to the thing suitable for his use on to be considered in the order of nature and the order of justice; for in the order of nature it is in determining insofar as it is not assured by actual possession; and in the order of justice it is determined that because of an effective possession of natural right, acquired through labor, without encroaching upon all other people’s right of possession...

Meek (1963) notes that in an 1805 obituary for Quesnay’s grandson, DuPont summarized Quesnay’s commitment to property as follows: “Respect for freedom and property demands that men and capitalists remain complete masters of the employment of their advances and their time, provided that there does not result from this any hindrance to freedom or damages to anyone’s property.”

Quesnay’s call for reasonable taxes (V), as well as his defense of free trade (XV and XXV), also support classical liberal ideals. One is reminded again of Adam Smith’s recipe for prosperity contained in the simple directions of “peace, easy taxes, and a tolerable administration of justice” (Smith [1982] 1775). In sum, Quesnay’s theory of natural law aligns broadly with subsequent classical liberal or libertarian visions of property (see also Bastiat 1995[1848a] or 2012[1850], or Rand 1967).

Quesnay’s support for state instruction of natural law (Maxim II) fits within a classical liberal conception (if not a libertarian/minarchist) vision (for the distinction between
classical liberalism and libertarianism/minarchy, see Tomasi 2012). Adam Smith writes similarly:

According to the system of natural liberty, the sovereign has only three duties to attend to; three duties of great importance, indeed, but plain and intelligible to common understandings: first, the duty of protecting the society from violence and invasion of other independent societies; secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice; and, thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain; because the profit could never repay the expence to any individual or small number of individuals, though it may frequently do much more than repay it to a great society. (Smith 1981[1776], IV.9)

A few of Quesnay’s maxims are border-line from a classical liberal perspective. Maxims XI, XII and XVII, are not offensive to liberty, even though they may not be necessary, and may not fall under the purview of prudent government. All three involve an encouragement of sound economics in agriculture, as well as the provision of the infrastructure needed for this support, which aligns well with Smith’s third duty of the sovereign under a system of natural liberty. Quesnay’s avoidance of state debt in Maxim XXX is certainly wise, though it seems to arise from a fear of financiers, which later classical liberals recognized as an economic sophism (see Bastiat 1995[1848b] on middlemen).

Other elements of Quesnay’s Physiocracy are more troubling. The next section outlines these conflicts.

4.4. ASSESSING THE PHYSIOCRATS FROM A CLASSICAL LIBERAL PERSPECTIVE (2): THE BAD

For all the classical liberal virtues found in Quesnay, four things clash with liberty and the free society: (1) proto-formalism; (2) despotism; (2) lack of appreciation for price signals and other forms of economic spontaneous orders; and (4) a constructivist vision of society.

First, Physiocracy is an early attempt at mathematizing and formalizing political economy. Rothbard (2006[1995], 374) leads his analysis of the Physiocrats’ technical economics with the assessment that “although the physiocrats had useful insights into political economy and the importance of the free market, their distinctive contributions to technical economics [starting with a theory of objective value] were not only wrong, but in some cases proved to be a disaster for the future of the economic discipline.” This brings us to the Tableau Economique, Quesnay’s formalization of the theory contained in the Maxims.5 For

5 We should note here that the Tableau is not mathematically sophisticated, and does not contain the complexities of modern mathematical economics. Our point is that the tableau is a formalization of the theory contained in the Maxims, and a precursor to Walrasian equilibrium theorizing, as we explain below.
details on the Tableau, see Fox-Genovese 1976, chapter 7 or Weulersse 1968[1910], 61-78. For a more tempered view, see Weulersse’s assessment that the Tableau’s purpose is more expository and pedagogical than thorough or mathematical (Weulersse 1968[1910], 64).

The Tableau lists eight causes of economic stagnation, none of which are patently objectionable: (1) poor fiscal policy; (2) excessive taxes; (3) excessive luxury consumption; (4) excessive litigation spending; (5) insufficient foreign trade; (6) insufficient internal commercial freedom; (7) vexations of country dwellers; and (8) insufficient net returns to agricultural investment. However, Cartelier (1991b, 37) explains that “Quesnay... uses [the Tableau] as a model, in the modern sense. The quantitative presentation is conceived as a formalization (a system of equations).” The theory of net product and the emphasis on a hydraulic, closed system, is a headache of deeply garbled proto-Walrasian thinking. In Rothbard’s words, the Tableau is “an incomprehensible, jargon-filled chart purporting to depict the flow of expenditures from one economic class to another. Generally dismissed as turgid and irrelevant in its day, it has been rediscovered by twentieth century economists, who are fascinated because of its very incomprehensibility. All the better to publish journal articles on!” (Rothbard 2006[1995], 375)

The Tableau, writes Cartelier (1991b, 37) “is a novelty. Even after more than a century of political arithmetic, nobody had dared represent the whole of social relations in the form of a schematic diagram that was purely quantitative, and nobody had dared reduce into an arithmetic table the order of society and the distribution of goods and services.” Coquelin and Guillaumin (1853, 368) conclude that “the works of the Physiocratic School gave an indirect impulsion to statistics.” And there is the problem. The Tableau – and more generally, the hydraulic, mechanical side of the Physiocrats – heralds much of what is wrong with economics (and especially macroeconomics after Keynes) today. We turn again to Rothbard’s vitriolic and entertaining pen where he describes the Tableau as a “piece of egregious folly” (Rothbard 2006[1995], 375-376):

Dr Quesnay’s Tableau Economique has been hailed for anticipating many of the most cherished developments of twentieth century economics: aggregative concepts, input-output analysis, econometrics, depiction of the “circular flow” of equilibrium, Keynesian stress on expenditure and consumer demand, and the Keynesian “multiplier”....

To the extent that Quesnay’s Tableau anticipates all these developments, so much the worse for both the forerunner and the later product!...[The] Tableau is holistic, aggregative, and macroeconomic, with no solid grounding in the methodological individualism of sound microeconomics.

The Tableau not only introduced ungrounded and unsound macro thinking into economics; it also laid up mischief for the future by anticipating Keynesianism. For it glorified expenditures, including consumption, and worried about savings, which it tended to regard as crippling the economy by “leaking” out of the con-
stant circular flow of spending. This stress on the vital importance of maintaining spending was faulty and superficial in ignoring two fundamental considerations: saving is spent on investment goods, and the key to harmony and equilibrium is price – lower spending can always be equilibrated on the market by a fall in prices. It can be laid down as a veritable law that any picture or analysis of the economic system that omits prices from consideration can only be crackpot; and the Tableau Économique was the first – but alas not the last – economic model which did precisely that.

While the analytic merits of macro concepts, input-output analysis and econometrics are highly dubious at best, they are surely worse than nothing if the numbers are incorrect. But Quesnay’s figures are spurious, for the France of his day or any other epoch. And the would-be great mathematician made many simple mistakes in arithmetic in the portrayals of his beloved Tableau. At best, then, the Tableau was elaborate frippery; at worst, false, mischief-making, and deceptive. And in no sense did the Tableau do anything but detract and divert attention from genuine economic analysis and insight.

Second, if Quesnay approaches the classical liberal vision and importance of individual spheres of action, there is also something missing in his conception of power. To be sure, Quesnay was writing at the height of the Ancien Régime. We must therefore be generous with his Maxim I – the claim that power must be centralized in one person and one locus, viz. the monarch – and this for two reasons (generally, see Fox-Genovese 1976, 304). First, the political context in which Quesnay was writing: it would have been political and professional suicide for Quesnay to attack the institution of absolute monarchy (he was, after all, personal physician to Louis XV). As Rothbard (2006[1995], 356) reminds us, “political economy was dangerous in that age of absolutism and censorship” and Mirabeau spent a few weeks in prison for his treatise against oppressive taxation. Second, Quesnay exhibited a pragmatic understanding of social change under absolutism. Coquelin and Guillaumin (1853, 360) explain: “judging that it would be easier to persuade a prince than a nation, that liberty of commerce and labor would be established more quickly... through the authority of sovereigns than by the progress of reason, [the Physiocrats] may have granted a bit too much to absolute power. They thought that general enlightenment would provide it with a sufficient regulation, a sufficiently powerful counterweight” (see also Fox-Genovese 1976, 65). Prudence and pragmatism notwithstanding, the very language of Maxim I is troubling, as it subordinates individual interests to the interests of society. In some ways, Quesnay presages Rousseau. Indeed, Fox-Genovese (1976, 9), explains that Quesnay always understood that in 18th century France the unfettered pursuit of individual interest might not result in the natural order he sought to establish: men could fail to behave “economically.” Quesnay believed that his introduction of arithmetic precision into economics provided a scientific rule that should dictate appropriate
political arrangements – and even the obedience of sovereigns. He was never willing, however, to trust the spontaneous development of the proper social-political order. Nature required the assistance of an absolute authority capable of forcing natural order upon recalcitrant humans.

Similarly, Cartelier (1991b, 57) explains that “legal despotism belongs to the natural order. It is not arbitrary and is the very antithesis of tyranny. It is merely a matter of instituting the order that is most advantageous and from which nobody would attempt to withdraw, if he knew it and he were illuminated by reason.” But legal despotism is still a despotism (ibid): “As a totalitarian school before its time, Physiocracy does not belong in the stream of classical liberalism..., where many have sought to place it, because of its support for free trade.” Harsh words indeed.

Third, Quesnay’s writings fail to provide any indication of knowledge of, or appreciation for, even a rudimentary understanding of spontaneous order. Within classical liberalism, spontaneous order sits in a central position that precludes many of the activities promoted by the Maxims. It is difficult for classical liberals to embrace a systematic treatment of an economy where price is treated as a tool of policy, irrespective of underlying consumers and producer actions. The pervasiveness of predictable effects in markets where prices are manipulated by external authorities provides both theoretical and empirical evidence that a spontaneously determined price is crucial to market clearing.

The final difficulty in Quesnay’s work is his vision of society, both ontologically and economically. Ontologically (and this may seem a quibble), Quesnay sees God and Nature, rather than the individual, as the basis of society. “Individualism à la Locke does not work for Quesnay’s project of political reform. The rejection of such a foundation leads him to place God or Nature at the origin of society” (Cartelier 1991b, 18-19). While there is something tempting about this vision of an authority higher than the monarch, the implications for individual rights can be troubling: “Quesnay subordinates the individual to society, and not the opposite. The natural order does not result from what is good for individuals. Rather, individuals are defined in function of natural society” (Cartelier 1991b, 49). But Quesnay’s vision of society goes beyond individual subordination to the common good; it moves from the theoretically ontological to the functionally interventionist. Quesnay exhibits an exclusionary preference for agriculture over all other forms of economic activity. Why agriculture and not industry or commerce? Why is land the sole source of wealth (Maxim III)? What of human ingenuity and human capital or entrepreneurship? Will Quesnay’s formalist sophistry suffice to convince us? As Rothbard (2006[1995], 372) writes, “from the standpoint of economic theory, the famous physiocratic tenet that only land is productive must be considered bizarre and absurd.” In his defense, Quesnay lived in a predominantly agricultural society, and most commercial activity centered on the transportation and sale of agricultural products. But this scarcely salvages or excuses the preposterous claim that land is the only productive factor. Interestingly, for all his support, Adam Smith recognized this problem. His primary criticism is that the Physiocrats failed to recognize the contributions made the national product by merchants and manufacturers. They, in essence, un-
dervalue manufacturing and mercantile activity making the same mistake as Colbert (who undervalued agriculture) and ignore the contributions that this sector makes by increasing the productivity of the land itself.

5. CONCLUSION

A modern-day libertarian/minarchist would not be pleased by the level of intervention that Quesnay proposes. But what of a modern-day classical liberal? (Again, for the distinction, see Tomasi 2012). Whereas a libertarian would blanch, a classical liberal could surely support Quesnay’s call for state education on natural law and infrastructure; after all, this echoes Adam Smith’s argument (Smith 1981[1776], V.1). Free trade is surely desirable, as is the enjoiner against sovereign debt. Ditto reasonable taxes, without privileges. But the case is less clear when it comes to a commercial policy aimed at supporting agriculture at the expense of finance (“financial fortunes are clandestine wealths that know neither king nor country”; Maxim XXIX). And one can see the outlines of support for an unsubtle guiding hand and the hubris of the social engineer. As Rothbard (2006[1995], 372) writes, the Physiocrats “were disgruntled with free market choice, and wanted to strengthen consumer demand for agricultural products in particular. High consumption of farm products was beneficial according to the physiocrats, whereas high consumption of manufactured goods would promote ‘unproductive’ expenses and crowd out desirable purchases of agricultural products.” Rothbard quotes Spiegel (1983, 192 in Rothbard 2006[1995], 373) on the reductio ad absurdum of the physiocratic preference for agriculture: if the Physiocrats “had been faced with a choice between laissez faire and intervention on behalf of farm price supports, they would have chosen intervention. The means to resolve the economic problem that was foremost in their minds was the development of domestic agriculture rather than unconditional reliance on private initiative within a framework of competition.” What is more, in a story that starts to smell of public choice, Rothbard demonstrates that “Quesnay – himself the son of a well-to-do farmer – was far more interested in subsidizing credit to farmers and keeping out competing borrowers than in stopping government debt”, hence his inconsistency on usury laws (Rothbard 2006[1995], 374). We should note, however, that Fox-Genovese (1976, 17, n. 7) argues that the public choice explanation proposed by Rothbard and others is overplayed: “Weulersse [1968[1910]] exaggerates the interest group approach at the expense of larger intellectual and ideological interpretations, in a manner reminiscent of Charles Beard’s work on the American constitution.”

What are we to conclude? Fox-Genovese (1976, 13) reminds us that “none of the many commentators on physiocratic thought has satisfactorily considered legal despotism, the primacy of agriculture, capitalist production, and free trade in grain as parts of a coherent whole”; she laments the tendency of scholars to engage in fragmentary treatments. But the Physiocrats are internally inconsistent. On the one hand, Quesnay suggests lowering taxes and decreasing government spending, within a framework of natural law and private prop-
erty rights. For this, he and the Physiocrats are to be lauded as friends of liberty. On the other hand, one sees in the Physiocrats early seeds of mathematically formalistic analysis, conjoined with the hubristic and conceited flavor that has haunted economics for the past century. The mechanical approach and proto-macroeconomic emphasis, the promotion of a benevolent despot, and the favoritism of “all thing agricultural” in the economy, all smack of Keynesian hydraulics and a policy of central planning.

Rothbard (2006[1995], 367) clarifies the problem for us: “The main stress of the Physiocrats was in two areas: political economy and technical economic analysis, and the difference in the quality of their respective contributions is so great as to be almost stupefying. For in general political economy, they were usually perspective and made important contributions, whereas in technical economics they introduced egregious and often bizarre fallacies which were to plague economics for a long time.” It would thus appear that we must, after all, disaggregate physiocratic thought (pace Fox-Genovese 1976).

It remains for us now to separate the classical liberal wheat from the interventionist chaff, applauding the Physiocrats for their legacy of liberty, while lamenting the interventionist seeds they sowed on the threshing floor of intellectual history.

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EUROPEANIZATION OF FDI SCREENING: WHAT MODEL FOR THE EU AND ITS MEMBER STATES?

ONDŘEJ FILIPEC

ABSTRACT

The main aim of this article is to assess the current debate of Foreign Direct Investments (FDI) security screening at the EU level in the context of the Europeanization concept. The article reveals various mechanisms EU member states are using for FDI screening and places them in the context of a framework for screening which was presented by the European Commission in September 2017. The article reveals the level of compatibility of the European Commission’s proposal with existing FDI screening mechanisms among selected EU member states and presents criteria for countries seeking to establish their own FDI screening mechanism.

KEYWORDS

FDI, Screening, European Union, Regulation

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1. INTRODUCTION

In September 2017 President of the European Commission (EC) Jean-Claude Juncker presented a proposal establishing a new framework for foreign investment screening. By this step he responded to the demand of France, Germany and Italy, who had experienced an unprecedented rise of Chinese investment in recent months, to create a common screening mechanism at the EU level. However, the EC proposal was of interest to other countries as well. Out of 28 EU member states only 11 countries so far developed some evaluation mechanism at the national level. The lack of an appropriate mechanism seemingly makes them open and vulnerable to foreign investors. Moreover existing mechanism procedures significantly vary among those EU member states that have some procedures.

Security screening of FDI is an issue of national and EU security which is becoming increasing important. The economic and strategic importance shall be not considered only in relation to the increasing interest of foreign powers in sensitive economic sectors but also in the context of the new doctrine of hybrid warfare. In this sense FDI may serve as a tool promoting detrimental interest and when related to problematic actors may be considered as a security threat.

The main aim of this article is to assess the current debate on FDI security screening at the EU level in the context of the Europeanization concept, especially as developed by Tanja Börzel (2002) or together with Thomas Risse (2000). However, assessing the validity of the concept is not the primary objective and Europeanization is taken only contextually. Nevertheless, in order to reveal the possible impact of the EC proposal at a national level the article focuses on the exploration of mechanisms of FDI screening at the national level in order to discover “how much change” (Radaelli 2000 p. 12) current proposal requires or how big a “misfit” exists (Börzel and Risse 2000 p. 5). This is necessary for predicting positioning for the future negotiations about the proposal.

This case study shall make two important contributions. It verifies the validity and test usefulness of the Europeanization concept on the new issue. And what is more important due to its comparative part it reveals various mechanisms EU member states are using for FDI screening, identifying key aspects of regulation which may help Member states which do not have the mechanism of FDI screening yet and to consider the establishment of one. As there are two goals, there are two principal research questions: (1) To what degree are existing aspects of the Europeanization concept applicable to the FDI screening proposal? And (2) What is the level of compatibility of the EC’s proposal with existing FDI screening mechanisms among EU member states?

For fulfilling these aims the article is divided into three parts. The first part focuses on the contemporary situation and the ongoing debate about FDI screening and places it in the context of Europeanization. There is no special part dedicated to the Europeanization...
tion concept as it has been discussed elsewhere (see for example Olsen 2002). The author assumes that the reader is aware of this concept. Instead the existing debate about FDI security screening is put into the Europeanization concept contextually. The second part is aimed at revealing mechanisms of FDI evaluation at the national level in various EU member states and reveals the level of consistency with the current EC proposal. In other words it reveals various mechanisms existing in the EU member states and the level of “misfit” vis-a-vis the existing proposal. The third part is deriving key principles from existing FDI screening models which might be used for the improvement of the FDI screening mechanism at national level or the creation of a common EU mechanism. However, as pointed out for example by Ha-Joon Chang (2004) the debate about regulating FDI has been ongoing for decades also in other non-EU countries (Chang 2004). Hopefully, this contribution will bring some points to the ongoing debate.

2. FDI SECURITY SCREENING: FIRST STEPS

FDI are generally seen as a positive stimulus for economic development. As pointed out for example by Corneliu Russu (2006) FDI helps in reception of investment capital while the availability of equity is absent or reduced. They also provide technology transfer helping to modernize technologies or develop new sectors and provide an opportunity to increase GDP in the targeted sectors (Rusu 2006 p. 51). However the presence of foreign capital is not desirable in all sectors of the economy and may cause harm or pose a security threat for the country. The threat to national security is related especially to critical infrastructure whose disturbance may cause dramatic consequences ranging from supply shortages to disruptions in public order. In the worst case scenarios unwelcome FDI in critical infrastructure may lead to the effects presented by Kahryn Gordon and George Mason (2008 p. 8):

- Shutting down or sabotaging a critical facility;
- Impeding law enforcement (e.g. carrying risk of facilitating law-breaking by organised crime or by terrorist organisations) or national security investigations;
- Accessing sensitive data or becoming aware of investigations by national intelligence or law enforcement agencies, including moving data or records offshore;
- Limiting government access to information;
- Denying critical technology or key products that are important for essential security investments to the government or moving them offshore;
- Unlawfully transferring technology abroad that is subject to export control laws;
- Undermining technological leadership in sectors important for safeguarding essential security interests;

3 Definitions of this term vary among EU member states.
Compromising the security of public or private networks with grave risk to public safety and public order;

Facilitating espionage or aiding the military or intelligence capabilities of a foreign country.

As pointed out further by the authors every investment is case specific and requires additional factors to be evaluated: investment to a nuclear facility is something different than investment into solar energy (see Gordon and Mason 2008 p. 8). However, despite some of the above threats being less probable, some areas beyond critical infrastructure may be considered as sensitive in terms of national or societal security. This is the case of media (both printed, social, on-line or streamed) which forms public opinion and is an essential aspect of a well-functioning democracy and country foreign policy orientation.

As presented in a study made by the Prague Security Studies Institute (2017) some actors behind FDI may be considered as a potential threat and thus should be approached carefully. These are especially foreign companies (both state owned enterprises or private enterprises with ties to states) from non EU/NATO countries, Sovereign Wealth Funds (owned by a problematic state), European or domestic enterprises closely linked to previous actors and generally enterprises with an unclear ownership structure (PSSI 2017 p. 2). In this regard sensitivity to foreign ownership varies among EU member states. As for Central and Eastern Europe especially FDI originating in Russia (or related to enterprises with a link to Russia) often poses a dilemma. Similarly, in various parts of Europe Chinese investments are evaluated cautiously. The problem of carefulness is however not limited to Russia and China, but also to other countries including Iran, Saudi Arabia and even Turkey.

In the last 20 years the EU was a very attractive target for FDI which largely oscillated. For example in 2004 they counted for 400 Billion USD, in just three years in 2007 they increased to 1.7 trillion USD and then fell down to 445 Billion USD in two following years. They again topped in 2011 to 851 billion, went down to 389 billion USD in 2014 and returned back to the top in 2016 representing 835 billion USD (World Bank 2017). The “Up and Down” curve of the overall EU FDI investment does not match significantly varying DFI investment curve in the individual member states (to a certain degree except the United Kingdom which had the most significant contribution to the EU’s FDI inflows share and thus the UK curve is most similar to that of the EU). The total amount of FDI however will not tell us anything about the risk of FDI.

The structure of the FDI regarding the state of origin varies among EU member states. In particular Chinese investments are progressively rising in the EU. As of 2016 Chinese companies invested 35 billion EUR in the EU which was on average a 77 percent increase compared to 2015 (Hanemann and Huotari 2017 p. 4). Investments from China were aimed especially at advanced sectors such as manufacturing, energy, transportation, information and communication technology, or entertainment. Moreover, they are merely concentrated on three “core” EU economies – the UK, Germany and France (Hanemann and Huotari 2017 p. 6). As pointed out in the study published by Ernst& Young (2016) within the first
six months of 2016 China invested in the EU more than 70 billion USD, which is as much as in 2013, 2014 and 2015 combined together (Ernst & Young 2016 p. 5).

As for 2016 in total 31 percent of Chinese investments were targeted at Germany. The largest transactions covered Midea’s acquisition of KUKA robotics maker (4,4 billion EUR), Beijing Enterprises’ acquisition of waste incineration and power generation company EEW Energy (1,4 billion) or CIC’s investment in BGP group worth of 1 billion EUR (Hanemann and Huotari 2017 p. 8). As pointed out by a Shanda Consult in 2016 Chinese mergers and acquisition in Germany grew by 246 percent and were thus 3.5 times higher than in the previous year (Shanda Consult 2017). And despite studies which have already mentioned the increasing importance of Germany in the Chinese investment strategy (see for example Frey 2005 or Hanemann and Huotari 2015), the speed of the rise in investment is unprecedented and renewed the debate about FDI screening.

This development is similar also in other countries. For example in the first half of 2016 there were 23 Chinese acquisitions or mergers in France (compared to 21 in the whole of 2015), 15 in Italy (compared to 15 in the whole of 2015), 10 in the Netherlands (compared to 9 in the whole of 2015) etc. (Ernst & Young 2016: 9). It is thus not surprising that Economic Ministers from Germany, France and Italy sent a joint letter to the EU commissioner for trade Cecilia Malström to prepare a framework for common FDI screening mechanism (Joint Letter 2017). They wrote: “As a consequence (of increasing FDI inflow) we are worried about the lack of reciprocity and about a possible sell-out of European expertise, which we are currently unable to combat with effective instruments”(Joint Letter 2017: 1). From the perspective of the Europeanization concept, these three states attempted to “upload” their national issue at the EU level and it is in-line with the claims of Tanja Börzel (2002) that this activity is made especially by “pace setters” (Börzel 2002 p. 196). As explored in the second chapter, all three states have extensive experience with FDI screening and may serve as a model example for other countries.

On 13th September 2017 the EC presented the proposal (EC 2017a) which is based on three particular elements. First, establishing an EU framework for FDI screening by its Members States on the grounds of security or public order (article 3), including transparency measures, rule of equal treatment among foreign investors and an obligation to ensure appropriate redress possibilities regarding decisions adopted under the review mechanism. Second, it establishes mechanisms of cooperation between the EU Member States and the EC which will be activated when a specific FDI may affect the security or public order of another member state. Third, it establishes EC screening aimed at security of public order or security in the cases where FDI may affect a project of EU interest (article 3) such as research (Horizon 2020), space (Galileo), transport (Trans-European Network for transport, TEN-T) energy (TEN-E) or telecommunications (EC 2017b).

In article 6 of the proposed regulation the EC stresses that the screening mechanism shall be transparent and not discriminate between third countries and that the member state shall establish timeframes for issuing screening decisions. It also focuses on the protection of confidential information and stresses that foreign investors and undertakings shall have the possibility to seek judicial redress against the screening decisions of the
national authorities (Article 6). In all the above aspects regulation is very general and gives some space for national forms of regulation. From the perspective or Europeanization the EC proposals develops both: institutions at the EU level in the form of a common mechanism but part of the regulation is aimed at developing structures within the EU member states which connects two from the five understandings of Europeanization summarized by Olsen (2002).

Article 7 presents obligations for Member States to notify the EC about existing screening mechanisms, provide annual reports on the application with specific information including FDI screened and undergoing screening, screening decisions prohibiting FDI, decisions subjecting FDI to conditions mitigating measures or information about sectors, origin and value of FDI (Article 7). Article 8 establishes cooperation mechanism under which Member States shall inform the EC and the other Member States of any FDI undergoing screening within 5 working days from the start of the screening. When decided that FDI is likely to affect its security or public order it provides information to the EC and other states. In the case the EC considers that FDI is likely to affect security or public order in one or more Member States it may issue an opinion. The issuing opinion is not linked, however, to provided comments (see Article 8 (3)) and the EC may act independently. Similarly, member states or the EC may ask within 25 days for further information from the state where FDI has been undertaken. Regarding information from other states or the opinion form the EC the Member state shall “give due consideration to the comments” (Article 8). In relation to Article 8 the so called “FDI screening contact point” shall be established in the Member states under article 12.

A special part of the regulation (article 9) is aimed at screening conducted by the EC itself (areas likely to affect a project of the EU). Here the EC is requesting powers to ask member states for further information and issue opinions (which are not legally binding act). Clear limits are set up “no later than 25 working days following the receipt of the information” for addressing opinions to Member states. Regarding information requirements (article 10) information submitted by the MS shall compose of:

(a) The ownership structure of the foreign investor and of the undertaking in which the foreign direct investment is planned or has been completed, including information on the ultimate controlling shareholder or shareholders;

(b) The value of the foreign direct investment;

(c) The products, services and business operations of the foreign investor and of the undertaking in which the foreign direct investment is planned or has been completed;

(d) The Member States in which the foreign investor and the undertaking in which the foreign direct investment is planned or has been completed conduct business operations;

(e) The funding of the investment, on the basis of information available to the Member State.
Despite article 11 of the proposed regulation stressing that information received shall be used only for the purposes of the regulation (FDI screening respectively) and that Member States and the EC shall ensure protection of confidential information, it is evident that the above mentioned information according to article 10 will be shared with the other 28 actors maintaining FDI screening points of contacts and the EC. Without any prejudice the increased number of actors involved in confidential data sharing increases the likelihood of information misuses due to intended (for example caused cyber attack or intentional dissemination by employees) or unintended violation of confidentiality.

This is, however, not the only negative aspect of the proposed regulation as it may create new obstacles for FDI. This was mainly the reason why the proposed regulation from the early beginning evoked opposition among some countries. For example already at the European Council summit in June 2017 some Nordic, Central and Eastern European countries showed hesitant reaction. As news source Politico pointed out Polish Prime Minister Beata Szydlo said that “Poland will firmly oppose protectionist measures in the European Union” (Politico 2017). Paradoxically, according to FDI Restrictiveness Index Poland is the second most restrictive country in the EU regarding FDI (OECD 2017) and a common EU mechanism may help Poland to set-up a more FDI friendly mechanism. But there is a point in that the proposed regulation may create new barriers by establishing deadlines and demanding additional information. Moreover, in many cases EU member states compete to attract FDI and sharing confidential information may lead to purposeful delays during the review process despite the final decision being up to the state receiving FDI as opinions are not legally binding acts.

There is, however, also an additional value of the system. First, the newly established mechanism is involving more actors and next to the dangers related to this issue there is also positive aspects the more eyes the better. Simply said FDI screening contact points may create a network and share information about subjects behind FDI, their experience and common practices. Second, establishing a common screening mechanism may lead to the “equalization” of FDI screening mechanisms. Due to shared experience countries which lack such a mechanism will benefit from increased security and countries that already have screening mechanism may use this common experience, simplifying their national measures and getting rid of the burden associated with overregulation which leads to undesired effects.

For this reason it is necessary to keep the screening procedure as little administratively demanding as possible in order not to discourage potential investors. As FDI Restrictiveness Index published by OECD suggests FDI regulations in some EU countries are al-

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4 Systems and levels of cyber protection vary in the EU member states. Moreover, some states are exposed to a higher number of cyber-attacks than others. The varying level of protection may lead to gaps in the system and make it vulnerable to cyber threats.

5 Screening is one of four types of restrictions (among sectoral equity limits, restrictions on key personal and other restrictions) under the index.
ready relatively demanding and require simplification. On the other hand some states seem to have almost no restrictions according to FDI Restrictiveness Index (2016). Thus states in the EU range from 0,11 in Austria (most restrictive in the EU), to 0,0 in the Luxembourg.\textsuperscript{6} In general FDI restriction in the EU is minimal to other countries, notably China (0,33), India (0,21) or Russia (0,20) and all are below OECD average at 0,07 (OECD 2017). This has implications for new EU FDI regulation: there is some space regarding the regulatory burden, however new regulation shall be fully consistent with national models or FDI screening in order to keep the EU as the most favourable target for FDI.

3. NATIONAL MODELS FOR FDI SCREENING

In the realities of the EU FDI may have an effect in the area of competition and thus fall under the common rules set for the common market. For this reason some competences are entrusted by treaties to the EU and some remain at the level of EU member states.

EU competence within FDI has been already envisaged in the Lisbon treaty. Consequently, FDI was placed under the EU exclusive competence which is based upon article 3 (I) (e) and article 207 (I) of the Treaty on the Functioning of the European Union (TFEU) as FDI is considered as supporting EU common commercial policy (Pedersen and Mouyal 2017). Despite the lack of a common mechanism for FDI screening the EC is already involved in EU Merger approvals under EU competition rules which is merely based on article 101 TFEU and further developed by the case Law of the Court of Justice of the EU. Similarly it has extensive powers based on article 102 TFEU related to the misuse of a dominant position in the common market.

However, this does not prevent member states conducting their own security screening. Despite the free movement of capital it is one of four freedoms related to the common market (and only freedom fully applicable also to third countries as stated in article 63 TFEU) there are some exceptions in favour of member states based on articles 63 to 66 TFEU. However, especially article 58 (I) (b) gives the member state a right “to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on the grounds of public policy or public security.” (TFEU, article 58 (I)(b)). This particularly means prevention in activities such as money laundering to support the financing of terrorism, but also allows member states to restrict FDI on the grounds of public policy of public security which is closely connected

\textsuperscript{6} Countries scored as follows: Austria (0,11); Poland (0,07); Sweden (0,06); Italy, Slovakia (0,05); Belgium, France, Ireland and the UK (0,04); Denmark, Greece, Hungary, Latvia, Lithuania (0,03); Germany, Estonia, Finland, Spain (0,02); Czech Republic, Slovenia (0,01) and Luxembourg (0,00) (OECD 2017).
to critical infrastructure or similar areas essential to the functioning of the state. Similarly, grounds of public policy allow FDI refusal or restriction due to its impact on the local environment, consumer protection or spatial and urban planning (see for example C-400/08 EC v. Italy). Moreover, Article 346(1)(b) TFEU excludes the defence sector (trade or production in arms, munitions and war material) which strongly relates to national security. It is important to note, that any restriction regarding free movement of capital shall not, according to article 65 TFEU, constitute a means of arbitrary discrimination or a disguised restriction. This implies that existing mechanisms at the national level shall be fair, transparent and proportional.

The rights regarding FDI screening resulted in the creation of evaluation mechanisms among several EU member states (summed up in table 1) which are further explored in order to evaluate consistency with the EC’s proposal with the aim to find the level of possible “misfit.” Moreover, it provides us useful data and an overview of key mechanisms upon which individual principles may be derived.

**TABLE 1: FDI SCRUTINY IN EU MEMBER STATES**

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Access</th>
<th>FDI Scrutiny Procedure</th>
<th>FDI Scrutiny Practice</th>
<th>Sectors of FDI Reviews/Limitations</th>
<th>Defence and/or Other Sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>yes (2015)</td>
<td>no</td>
<td>n/a</td>
<td>n/a</td>
<td>yes (Maritime transport)</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>yes (2015)</td>
<td>no</td>
<td>n/a</td>
<td>n/a</td>
<td>yes (Banking, Insurance and Defence)</td>
</tr>
<tr>
<td>Denmark</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes (Electricity and Gas Infrastructure)</td>
</tr>
<tr>
<td>Germany</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Estonia</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Ireland</td>
<td>yes</td>
<td>no</td>
<td>n/a</td>
<td>n/a</td>
<td>yes</td>
</tr>
<tr>
<td>Greece</td>
<td>yes (2015)</td>
<td>no</td>
<td>n/a</td>
<td>n/a</td>
<td>yes (Land)</td>
</tr>
<tr>
<td>Spain</td>
<td>yes</td>
<td>yes</td>
<td>yes (non-defence)</td>
<td>Yes (defence)</td>
<td>no</td>
</tr>
<tr>
<td>France</td>
<td>yes (2015)</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td>Country</td>
<td>Market Access</td>
<td>Limitations or Prohibitions</td>
<td>FDI Scrutiny Procedure</td>
<td>FDI Scrutiny Practice</td>
<td>Sectors of FDI Reviews/ Limitations</td>
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<tr>
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<td>no</td>
<td>no</td>
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<tr>
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<td>yes (no legal framework)</td>
<td>yes (recently energy, transport)</td>
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</tr>
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<tr>
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<td>Yes (Supreme Defence Council – no action yet)</td>
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<td>n/a</td>
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<tr>
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<td>yes (2015)</td>
<td>no</td>
<td>no</td>
<td>yes</td>
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### Table 1: Overview of FDI Scrutiny Practices in Selected EU Member States

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Access</th>
<th>FDI Scrutiny Procedure</th>
<th>FDI Scrutiny Practice</th>
<th>Sectors of FDI Reviews/Limitations</th>
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<td>Limitations or Prohibitions</td>
<td>Formal or Informal</td>
<td>Case-by-Case Scrutiny</td>
<td>Automatic</td>
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<td>yes</td>
<td>Yes (non-defence)</td>
<td>yes (Defence)</td>
</tr>
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<td>Sweden</td>
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<td>no</td>
<td>no</td>
<td>No</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
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</tr>
</tbody>
</table>


As shown in table 1 there are EU member states with considerable experience with FDI screening.

**UNITED KINGDOM**

Due to the liberal economic environment and great emphasis on trade the UK has been for decades an attractive target for FDIs and thus it is not surprising that the country developed a screening mechanism which allows a swift reaction to the government while being transparent and unburdensome. The EC proposal came at the time when the UK is preparing for Brexit and considers improvement of national rules for FDI screening. The UK government is interested in new EU wide rules because the UK may act as a third party to the system after Brexit. David K. Lakhdir and Anna L. Christie (2017) point out, that despite the fact that Brexit may happen soon the UK is still bound by EU law on acquisitions and mergers despite the Conservative Party indicating during 2017 elections possible reforms of the rules on takeovers and mergers, especially in relation to UK critical infrastructure (Lakhdir and Christie 2017 p. 5). According to authors the debate has been accelerated also by the Department for Business Energy and Industrial Strategy (BEIS) which oversees the construction of a new nuclear power plant at Hinkley Point C which is attracting Chinese investments and is under additional governmental scrutiny (Lakhdir and Christie 2017 p. 5). As shown further, the debate is still very alive in the UK Parliament.

UK Law on FDI screening is based on the Enterprise Act of 2002 which allows the UK Secretary of State to intervene in the FDI in the case of national security, plurality of media and maintenance of the UK financial system stability. Specific rules for interventions are related to the UK and in some cases of EU mergers. In these cases there is set a specific threshold for legal liability: one example is that the acquired company must have an annual UK turnover of more than 70 million GBP and/or the merging company must collectively supply or acquire 25 percent or more of goods or services, provided that the merger results
in an increment to that share (Hands 2017 p. 3). As for now, David K. Lakhdir and Anna L. Christie claim that there have been only seven public interest interventions on national security grounds such as Hytera Communications’ proposed acquisition of Sepura (David K. Lakhdir and Anna L. Christie 2017 p. 6). Intervention regarding maintenance of the stability of UK financial system was based on the Enterprise Act and newly added in 2008 and as such used only once in the case of the proposed merger of Lloyds TSB and HBOS (David K. Lakhdir and Anna L. Christie 2017 p. 6). Theoretically the government can also invoke the Industry Act of 1975 but to the knowledge of the author this has never happened.

The UK restricts investment in several privatized companies including BAE Systems (aircraft and defense) or Rolls Royce (aerospace industry) where no foreign shareholder may own more than 15 percent of these enterprises. These “golden shares” are de facto blocking FDI in these specific companies and sectors (Riehmer et al. 2017 p. 8). Moreover, there is specific national legislation for certain areas. For example investments in energy or power generation require environmental approval or investment in radio and land-based television broadcasting is subject to licensing (export.gov 2017). This is a similar situation to other EU countries. Some rules are however more strict than those of the EU: for example freeing equity ownership in air transportation is limited in the EU to 49 percent for enterprises outside the European Economic Area, but the UK government may according to the Industry Act prohibit transfer to foreign owners of 30 percent or more due to interest contrary to the country interest (export.gov 2017).

It is important to note that the EC proposal invoked the debate regarding specific national interest. For example from communication between Minister of State for Trade Policy and Minister for London Greg Hands and Lord Boswell of Aynho – Chair of the European Union Select Committee we know that the minister was concerned about the ability of the UK to acts swiftly in cases of genuine national security concern and it was unclear how the process of sharing information could prevent the UK from acting swiftly (Hands 2017 p. 1). He also worried about prolonging the screening process up to 10 weeks due to deadlines proposed by the EC, as in the UK Ministerial intervention due to security reasons is conducted in under five weeks (Hands 2017 p. 2). He mentioned that compulsory sharing of sensitive information about live cases poses significant risk and that the UK is already sharing information with its partners, however on a voluntary basis (Hands 2017 p. 2). Greg Hands summarized several other questions related to consistency with the UK national mechanism. Some are evident, for example the system lacked notification obligation and prior clearance which makes it partially vulnerable.

As mentioned earlier, UK is on the way to enhancing its system. This enhanced system will be most probably based on the Green Paper “National Security and Infrastructure Investment Review” which is setting out national security reforms. One of the proposals updates turnover thresholds and share of supply tests within the Enterprise Act of 2002 in order to allow the Government to examine and intervene in areas currently outside the thresholds. This shall cover especially dual use goods and military material or advanced technology sector. The government proposes to lower the threshold from 70 million GBP to just 1 million GBP and remove the requirement for the merger to increase the share of
supply to 25 percent or higher as turnover or shares are not very reliable indicators of risk (Hands 2017 p. 3). The second set of proposals is aimed at following the example of other developed, investment-liberal countries to make more substantive changes in a more long term and general nature (Hands 2017 p. 3). To sum-up, despite Brexit the UK is interested in setting up some common rules which will not undermine the possibilities to shift response and favour mainly cooperation on a voluntary basis regarding the sharing of information. Moreover, existing debate (see Lords Select Committee 2017) and attempts to strengthen national discretion to control FDI shows that the UK is considering FDI security seriously.

GERMANY

Germany, as the EUs biggest market, has had a rich experience with FDI screening. The issue got even higher importance when Chinese Midea Group took over German top robotics specialist KUKA and raised questions about security issues. For this reason Germany has already decided to strengthen the regime for the evaluation of FDI before the EC presented (upon the request of Germany, Italy and France) its proposal. The German attitude is, however, interesting. As noted by Krause et al. 2017), the Free State of Bavaria requested Bundesrat to adapt resolution entitled “Foreign Investment – securing technological sovereignty.” The Bundesrat considered it appropriate that control and prohibition of options shall be reciprocal – that investors from countries with restrictive markets shall be subject to stricter screening and that FDI shall be prohibited if not primary driven by market economy considerations (Krause et al. 2017). However, as pointed out by the authors, Federal Government amended Foreign Trade Regulation only in part.

New Foreign Trade Regulation (Außenwirtschaftsverordnung) entered into force on 18 July 2017. Foreign Trade Regulation, as amended, has two regimes: one is sector specific investment in the defence sector and cryptography industry (Sec. 60 and further) and second is related to cross-sector review for all other sectors (Sec. 55 and further). In general, the German Ministry of Economic Affairs (Ministry) has the authority to review investments from non EU/EFTA directly or indirectly acquiring 25 percent of the voting rights in German businesses and has the right to prevent investment on the grounds of public order or security. Similarly to other countries sector specific rules cover companies manufacturing or developing goods listed in Germany under Part B of the War Weapons List, special engines or gearboxes for tanks and other military vehicles or produces IT security components. It also requires screening of companies manufacturing goods listed in the German Export List (Annex 1) including fire control systems, weapon sighting devices, target acquisition equipment, special armour, various sensors, equipment for military training, robots, etc. Due to the sensitive nature all non-German investor undertake
As pointed by Krause et al. this part has been largely amended especially by the new anti-circumvention rule (Sec. 60(2)1), which extends the screening period from one month to three months. Moreover, the ministry got new powers to ask all parties to the transaction (not only the purchaser as previous), and the screening period is suspended during negotiations between Ministry and the Purchaser (Krause et al. 2017).

Similarly cross-sector investment screening has been significantly amended. For example the scope of application has been clarified by a non-exhaustive list of examples of sensitive businesses with particular emphasis on critical infrastructure, and the anti-circumvention rule addressed potential illegitimate bypassing of the screening procedure (Krause et al. 2017). According to Sec. 55 (1) 2 of FTR, FDI aimed at some sectors may be considered as a threat to public order or safety. These consist of operators of a critical infrastructure 7 as defined by the Act on the Federal Authority for Information Security (Energy, information and telecommunications, transport and haulage, health, water, nutrition and financial and insurance sector, development or modification of industry-specific software for the operation of Critical infrastructure (software associated for operation in the above mentioned areas), operators of communication systems providing public services, operators providing cloud computing services and owner of enterprises providing components or services of the telematics infrastructure.

The FTR screening procedure is based on notification requirements (in writing to the Ministry) which are necessary for investments in critical infrastructure and establishes the possibility to combine notification with the application for the certificate of non-objection (Unbedenklichkeitsbescheinigung). In general after the notification the Ministry has a 3 month period for screening the FDI but the certificate of non-objection may reduce the deadline to two months and contributes to the decrease in the doubts of the Ministry (Krause et al. 2017). Despite there being no sanctions for violating the notification, the Ministry may start the screening process within five years after signing the FDI contract. Similarly, notification of the transaction or knowledge from other resources triggers a three-month screening period. In the end the Ministry has the right to prohibit or limit the acquisition in four months after receiving the complete documentation regarding the transaction (sec 59 (1)). Similarly to sector specific rules, the screening period is suspended when the Ministry is negotiating and the Ministry may ask all parties for additional information and when necessary start the in-depth process which may last up to 4 months and in sector specific areas up to 3 months (Richmer et al. 2017).

To sum up, Germany has also created more space for its institutions which might be a result of the greater interest of foreign investors creating more workload and challenging

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7 According to the Federal Ministry of the Interior regulation facilities qualify for critical infrastructure as they ensure energy, water, nutrition, information technology or telecommunications for at least 500,000 individuals (see Verordnung zur Bestimmung Kritischer Infrastrukturen nach dem BSI-Gesetz).
institutional capacity. Moreover, some FDI has had a strong political impact and challenged security as they were aimed at critical infrastructure. The German amendment has been rational and based on its vast experience. Since 2008 to November 2016 the Ministry undertook in total 338 reviews of foreign acquisitions of domestic companies (ECFR 2017).

The German system presents the complex regulation of FDI (requiring harmonization with other pieces of law) with clearly set deadlines and responsibilities where the burden of information is laid down on the investor who risks wasted investment in the case of non-cooperation. However, contrary to the UK the deadlines are set more restrictively for the investor. However, this disadvantage is compensated by the certificate of non-objection.

FRANCE

The French mechanism is based on the French Monetary and Financial Code (*Code monétaire et financier*) and also restricts FDI by The decree 2014-479 which expanded the list of sectors where the investor is required to seek authorization from the French Ministry of the Economy. Similarly to Germany it allows FDI review on the grounds of public order, public security or interests of national defence and similarly to other countries conditions and the degree of control vary depending on sector or activity conducted.8 In general, the French system distinguishes between EU/EFTA investors and non-EU investors who are subject of extended screening in some additional areas where EU investors do have easier access. For example non-EU members are subject to screening in areas of gambling; private security services; research, development and production of certain pathogens or toxic substances; wiretapping and communications interception equipment; testing and certification of security for IT products and systems; goods and services related to the information security systems of companies managing critical infrastructure; dual-use (civil and military) items and technologies; encryption services; the activities of firms entrusted with national defense secrets; research, production or trade in weapons, ammunition, and explosive substances intended for military purposes; and any business supplying the Defense Ministry with any of the above goods or services (see Riehmer 2017 p. 8). Decree 2014-479 added another five sectors: energy infrastructure, transportation networks, public water supplies, electronic communication networks, public health, and installations/works vital to national security.

Similarly, Non-EU enterprises are subject to screening in the case of any investment leading to an acquisition of 33.33 percent or more voting rights in the concerned enterprise or involves any part of such a firm that has established headquarters in France. This FDI is subject to prior approval by the government (Häger and Dackö 2017 p. 3) and in reality may require the consent of several ministries. This is contrary to EU member states FDI which are subject to screening which is only aimed at the “control” of some enterprise.

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8 Similarly to the UK, 1993 privatization law allowed the government to maintain "golden share" in some companies on the ground of security and national interest such as in Gaz de France (energy) or Areva (nuclear energy).
As pointed by Erica Häger and Carolina Dackö (2017), all foreign investors have to apply for authorisation prior to investing in certain sectors. Possible non-compliance includes, contrary to Germany, criminal penalties and may lead to the nullification of the transaction. However, if a decision by the authority is not made in two months, the authorisation is deemed granted (Häger and Dackö 2017 p. 3). The French system seems to be less restrictive than the German but has stronger tools including sanctions. Target companies have their own strong intervention rights regarding the management, special voting rights for long-term shareholders or consultation of work councils (see Riehmer 2017 p. 8). On the other hand the FDI partner may contest the FDI regulatory decision before the administrative law courts. However, the systemic setting creates no pressure on the authority while it partially removes the burden to act as authorisation is deemed as granted in the case of non-decision. This system has been proven as ineffective in the case of Chemical regulation until national systems were amended by comprehensive REACH regulation which transferred the burden of proof to the chemical industry. Moreover, the threshold of 33.33 percent may be too high as Germany and the UK operates with 25 percent.

FINLAND

Among the other countries which have in place screening mechanism is Finland which is considered to be a “hub” for investments especially in research and development due to its highly skilled and cost-effective workforce and the improving profile in technology. For this reason in 2016 in total 270 new foreign companies entered the Finnish market and many companies declared plans to invest especially in IT technologies (IIF 2017). Interest in investments in Finland falls under the Act on the Monitoring of Foreign Corporate Acquisition which entered into force on June 2012 which deals especially with investments into the defense sector and companies deemed critical for the vital functioning of the state and society.

Similar to Germany, Finland also applies a cross-sectoral and sector-specific screening process but differ in the threshold levels applied and the origin of the acquirer targeted by screening. In Finland sectoral screening is related to areas of production or supply of defence equipment, goods or services related to defence and business producing dual-use goods. Screening in the cross-sectoral areas is more restrictive than in Germany. The subjects are all non-EU/EFTA investors aiming at the acquisition of a Finnish enterprise with a threshold of 10 percent of the voting rights or more, without regard if the acquisition may threaten the national interest (Sunessen and Hansen 2018 p. 39). Moreover, all non-EEA persons or companies starting business in Finland (especially in the very regulated areas such as banking or the insurance sector) must obtain a license or notification when starting their activities (Santander 2017).

The Finnish legislature established the prior authorisation mechanisms where the acquirer is obliged to seek the prior approval from the Finnish Ministry of Economic Affairs and Employment which swiftly cooperates with other ministries, especially the Ministry of Defense, Finnish Defense Forces, National Emergency Supply Agency, Finnish Border
Guards and other actors when necessary. The duration of the screening procedure varies but typically takes between one to three months.

It is important to note that filling an application or notification is voluntary and to the knowledge of the author this is required to be filled in Finnish or Swedish. Moreover, the notification has no official template but shall include information on the monitored pre- and post-transaction ownership structure and the acquiring entity’s ownership structure (export.gov 2017b). However, the Ministry has rights to request information regarding the investment and has powers to regulate them.

In the sector specific screening the acquisition is on an “on hold” basis. It is pending and ineffective until the final approval of the ministry, and there is no official time line set for the screening. This is different to cross sectoral screening where the acquisition is effective and the acquirer may proceed until stopped and reversed in the case by the Ministry (Sunessen and Hansen 2018 p. 40). A transaction is considered approved if the Ministry does not request additional information, initiate further proceedings (within a six week period) or refuse to confirm the transaction within three months (export.gov 2017b). At any time the Ministry can control the investment already completed. According to data between 2012 and 2016 Finland dealt with 35 applications (Sunessen and Hansen 2018 p. 40).

The Finnish system seems to be less formal without creating institutional overload (in Finland, only two people are employed to make FDI screening compared to a whole department in Germany as mentioned in Sunessen and Hansen 2018). Reporting on a voluntary basis with a relatively weak formal framework for deadlines may leave some level of uncertainty among investors. Moreover, it seems that regarding cross sectoral investment the burden of facts is on the state authorities.

ITALY

In Italy the foundations of FDI screening has been laid down in Law Decree 21/2012 which is giving the government powers in relation to companies exerting control over strategic assets in specified industries such as defense and national security or energy, transport and telecommunications. The government has very extensive powers which may result in the vetoing of investment resolutions, blocking investments or imposing special terms and conditions for FDI when a threat to defence or national security and slightly less powers apply for the grounds of public interest in transport or energy sector (Sunessen and Hansen 2018 p. 41). These powers are set by a special law and which has been recently extended by Presidential Decrees 35/2014 and 86/2014 to the defense sector or other areas related to national security. It is important to note that investments in the defence sector and other sectors involved in the maintenance of public safety are not open to foreign investors (Stander 2017b). Some restrictions are related to airline operations and the shipping sector and investment is limited only to EU member states in the film industry (export.gov 2017c).

Italy runs its registration website under the Chamber of Commerce (http://www.registroimprese.it/) which helps potential investors to fulfil all the necessary formalities which are mainly related to telecommunications and press, airline and shipping, electricity and gas or petroleum exploitation. Investment in these sectors requires prior authorisation. How-
ever, shares in some Italian companies are restricted under the “Golden Power” rule which is especially related to the above mentioned sectors. In recent years the Italian government was sued for holding a monopoly in other areas and despite the practice of golden shares being limited today, there are still companies controlled directly by government or through state-controlled sovereign wealth fund Cassa Depositi e Prestiti in shipbuilder Fincantieri (72.5 percent), Poste Italiane (64.7 percent), ENEL (25.5 percent), Eni (30 percent), defense conglomerate Leonardo-Finmeccanica (30.2 percent), natural gas infrastructure Snam (30.1 percent) or electricity transmission provider Terna (29.85 percent) (export.gov 2017c).

The Italian system is very restrictive due to various exceptions for investment and the “golden rule” legislation which still remains. However, the formal screening process is made only within a limited number of sectors (defense, transportation, energy or telecommunications) and where there are considerations of the market because of specific thresholds.

**POLAND**

Poland recently adopted an Act on the Control of Certain Investments, which entered into force on 30th September 2015 and set up provisions for the screening of acquisitions in energy generation and distribution, petroleum production, processing and distribution; telecommunications as well as manufacturing and trade with explosive, weapons and ammunition etc. However, some sectors such as land acquisition, broadcasting, air transportation etc. are covered by other pieces of law and set certain limits (for example non-EU persons are limited to 49 percent ownership in companies operating in air transport, radio and television broadcasting, airport and seaport operations, etc.). It is interesting that the thresholds for foreign participation dates back to the late 1970s (Jadach 1985: 75).

The adoption of the Act on the Control of Certain Investments has been strongly criticized from the very beginning due to its restrictive, protectionist attitude which is also considered contrary to elements of European legislation (see Caramihai 2016) and some authors such as Andrzej Mikosz and Piotr Moskela (2015) consider the result as a “hostile investments defense system” (Mikosz and Moskela 2015). It is important to note, that the Polish interest in reviewing the law was encouraged not by Chinese investments (such us in Germany or Italy) but by Russian attempts to take over key companies related to national security, such as Grupa Azoty by the Russian Acron company.

The acts according to article 1 sets out rules and the control mode of some investments involving the purchase of shares, of all rights and duties of a partner who has the right to run the company’s affairs or the right to represent the company partnership, enterprise or its organized part resulting in the acquisition or achievement of a significant participation or acquisition of domination over the company, being subject to protection and sets out penalties for violation.

The Act set up new rules for the sectors (defined in the article 4) where a special list of companies is established. If the investment is changing shares in one of those companies by more than 20 percent then the investor has to apply to the Minister of the State Treasury...
who has been established as a third authority (next to the president of the Office for Compensation and Consumer Protection and the Financial supervision Authority) who can veto the investment. The new law set up a deadline of 90 days for the decision and when the Minister makes an objection then the transaction is blocked (article 9).

If the investor bypasses the authorities, then the investment is illegal and the investor may face severe sanctions including a fine of up to 100,000,000 PLN (25 mil. EUR) or the investor acting on behalf of the legal person may face imprisonment between 6 months to 5 years (Article 16). Compared to other countries Polish law has a strong deterrent in the possibility of issuing sanctions.

Polish law is complicated due to the possible non-consistency with the Court of Justice rulings about “golden shares” (CEC vs. Italy) and concentration of powers within one entity. As pointed out by Mikosz and Moskela, the Minister of the State Treasury has the most powerful position regarding the decision which exercises also its rights from shares owned by the State Treasury. As they point out, objection cannot be based on state economic interests, which makes the role of the ministry very difficult (Mikosz and Moskela 2015). Moreover, they stress that the act may potentially complicate transformations performed within the capital group due to a lack of an exemption for the acquisition or achievement of a significant participation. Moreover, as pointed out by Georgina Caramihai (2015) new Polish law may violate the principle of non-impairment imposed in its various bilateral investment treaties. For the above mentioned reasons Polish law may be problematic, especially due to further possible procedures before the Court of Justice of the EU.

AUSTRIA

Historically Austria suffered from FDI overregulation and had an unattractive position which was close to the Iron curtain (OECD 2007: 120). Today however at a certain level of abstraction the FDI screening procedure in Austria is very similar to other countries as it is based on relevant stake and specific industries. The Austrian Foreign trade Act (FTA) or Außenwirtschaftsgesetz of 2011 requires in advance issued by the Austrian Ministry of Economic affairs for all investors seeking acquisition of more than a 25 percent share in enterprises in certain areas while having sales over 700,000 Euro per year (§ 25a of FTA). Restrictions apply especially to strategic sectors and may be limited on the grounds of national security or the safe provision of public services. These restricted sectors involve defense and security services, services of public order, safety, procurement or crisis services including hospitals, ambulance, medical services, fire fighters, civil protection services, energy and gas supply, water supply, telecommunications, railways, road traffic, universities, schools or pre-school institutions. The list of sectors covered is extensive and goes beyond the classical critical infrastructure. Moreover, the federal and state governments maintain at least a 51 percent share in all electricity generation and supply companies (Santender 2017d).

Similarly to other EU countries, the regime of FDI screening applies for non-EU investors who may be subject to two regimes: The first regime is called “ex ante approval” and usually takes one month from the submission of the application. When necessary the
authority may decide about an “in-depth” review lasting another two months. Within the ex-ante regime the investors shall submit applications before entering into a legally binding commitment to acquire the relevant stake or announcing the launch of a public tender offer with respect to the target of the investment (§ 25a of FTA). Usually, a transaction is approved after one month, and only a limited number of cases enter into in-depth evaluation. Similar to other countries, when the Ministry of the Economy does not publish its decision granting investment or does not initiate an in-depth procedure then the transaction is deemed as approved which transfers the burden to act to the state institutions. The second regime is called “ex officio review” (for further information see § 25a of the FTA).

OTHER EU STATES

Some sort of limited or unofficial screening is also made in some other countries. For example in Denmark screening of FDI applies to security sectors, and the country limits shareholders in several sectors related to national security. Limits apply to aviation and defense material where the Minister of Justice has to approve the foreign ownership of more than 40 percent of the equity or more than 20 percent of the voting rights. Investment in hydrocarbon exploration requires 20 percent participation by the Danish government. There are limitations for the maritime sector, real estate and securities trading as well (export.gov 2017d). Latvia, the Netherlands and Slovakia lack a formal legal structure and make screenings merely on a case by case basis (Grieger 2017: 6).

Portugal is in many aspects similar to other countries. Foreign investors in Portugal are required to register for statistical purposes within 30 days of its investment. There is a special procedure for the “projects presenting a particular interest to the Portuguese economy” (projects with a value over 4.9 million EUR, creating many jobs, aimed at industrial reconversion, making key regional investments or introducing new technologies) are the subject of a specific procedure under the Institute for Investment, Trade and Tourism. Investments in several sectors (defence, water management, telecommunications, railway, maritime or air transport) are more restricted and require the government’s approval and in the case of financial services also the approval of the Bank of Portugal (EU countries) or the Ministry of Finance (non-EU countries).

In Spain we can find similar restrictions limiting the activities of foreign persons in relation to defense, gambling, television, radio or air transportation, setting specific requirements. Individual ownership in these sectors is usually limited to a 25 percent share. The interesting point is the reciprocity clause (art. 25.4 of General Audiovisual Law) which states that a foreign company must have foreign ownership laws which permits a Spanish company to make the same transaction. Basically it means the rule of a 25 percent share of a company holding terrestrial television broadcasting or 50 percent share for two or more companies in aggregate (export.gov 2017e).

In Lithuania investments based on foreign capital are prohibited in sectors related to security and defense and in several other sectors the government issues permission or a license (especially in relation to activities that pose a risk to human health, life or environment). This covers also manufacturing and trade with weapons. The screening of FDI
aimed at state property or municipal property is made by the State Property Bank. The authority evaluates the size and record of the company behind the FDI in order to determine possible non-suitability of the acquisition (for example due to criminal records). For example in 2003 Lithuania intervened in the FDI from Italian wine company Bosca which sought to take over Lithuanian alcohol producer Alita which resulted in the famous case Bosca vs. Lithuania (Case No. 2011-05).

To sum up, all countries limit some sectors which may be targeted by FDI. The scope of sectors significantly varies. While some governments go beyond the golden share rule, others allow limited investment also in the areas of security and defence. Most countries distinguish between investors from the EU, EFTA, EEA or OECD and others who usually have more restrictive access. The complexity of screening varies as well as deadlines and legal obligations to publish the decision or to apply for screening. Some countries do not apply penal sanctions for violations (despite the fact that investment can be halted) and some have introduced formal sanctions for non-compliance with Poland being the extreme example. This drives us to the question about key principles on which the new mechanism may be built or the old mechanism adjusted.

4. KEY PRINCIPLES OF FDI SCREENING MECHANISM

The above overview of the mechanism provokes several key questions which in sum create a regulatory system. There are seven key questions whose answer may lay the foundations for the FDI screening mechanism:

Q1: What is the identity of subject behind the FDI?

Investors may come from countries with the absence of entrepreneurship regulation or serve for the purpose of a foreign power who seeks to extend its control over key enterprises. For this reason FDI shall be aimed at revealing the identity of the investor (e.g. ties, share structure, the origin of the capital, nature of activities etc.). From this perspective investors from developed countries, especially EU, EEA or OECD represent a lesser threat than investors from economies that are characterized by central planning or state interventions. For this reason the FDI screening mechanism shall distinguish between countries of origin and adjust the procedure accordingly. This will help to save institutional capacities and costs related to FDI as employees may concentrate on the FDI from problematic countries.

Q2: Shall reciprocity be required?

The first question is related also to reciprocity. To a certain degree distinguishing between investors from economically similar countries is a sign of reciprocity in the notion “business for business”. Imposing more restrictive conditions on investors from countries with deliberate economies may create pressure and encourage further economic liberalization in those countries which will be a benefit. In this sense the FDI screening mechanism
may play an education role. Another issue is an explicit clause requiring reciprocity, such as in the case of Spain in relation to audio-visual sector). On the one hand it helps to get “control for control” among countries but in practice the rule is merely redundant.

Q3: Is FDI directed to the sector of critical infrastructure or other areas essential for the proper functioning of state?

It is essential for state security to restrict access of FDI into defence and other areas aimed at maintaining public order as FDI may lead to the outflow of sensitive information, technologies or even infiltration. However, security interests are going far beyond defense and are related especially to critical infrastructure. In this sense the FDI screening mechanism can be to some degree linked to sectors covered under the act defining critical infrastructure sectors. Here the states shall consider keeping a “golden share” in some companies, but not preventing FDI as they might have some positive effects in those areas. Regardless of the share FDI into critical infrastructure shall pass in-depth screening and be the subject of approval. There are, however, some other sectors going beyond critical infrastructure which might be crucial for the functioning of the state or preserving its identity. This is related especially to media or the film industry.

Q4: What is the amount of the FDI and intended/expected effect the economic sector/particular enterprise?

Except defence, critical infrastructure and areas essential for functioning of the state the FDI screening process shall be as little demanding as possible. Some sectors do not deserve greater attention and the size of some FDI is not significant. For this reason regulation shall establish further criteria for FDI screening aimed at the size of the investment or impact resulting in percent share in the enterprise which will influence input for FDI screening. It is possible to combine both variables with differentiation between EU/EEC/OECD members and other states. For the first category FDI screening shall apply from a higher value (share) than for the second category. It is worth distinguishing procedures and work for example by notification (compulsory) and request for approval.

Q5: How many phases shall FDI screening be based on? Is there a need for an “in-depth review”?

Distinguishing between various scenarios saves institutional capacity. However, in the case of doubt or when FDI is aimed at critical infrastructure it is worth establishing an in-depth review which may involve more security actors including intelligence agencies. However, in order to make screening as swift as possible an in-depth review shall be used rather in exceptional situations and on transparently defined grounds in order not to discourage investors. Yet, there is a point in establishing in-depth screening as compulsory for certain investments regarding critical infrastructure and sectors central to the functioning of the state (SCFS). FDI screening authority shall have powers to ask for further information and initiate an in-depth screening on justified grounds. After screening is completed the FDI screening authority shall have the right to limit investment or set up specific conditions. Moreover, while notifications shall be responded to in a certain time period, in the case of
a request the investor shall wait for a final decision from the authority (within a set deadline) and the investment shall not be deemed granted. The principle may be seen applied in table 2.
### Table 2: Example of the Application of Differentiation Principle

<table>
<thead>
<tr>
<th>Investor</th>
<th>FDI area</th>
<th>Criteria</th>
<th>Form of application</th>
<th>FDI Screening</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Regular</td>
<td>In-depth</td>
</tr>
<tr>
<td>From EU/</td>
<td>Critical</td>
<td>None</td>
<td>Request</td>
<td>Compulsory</td>
<td>Compulsory</td>
</tr>
<tr>
<td>EEC/OECD</td>
<td>infrastructure or SCFS</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>countries</td>
<td></td>
<td>Under 100 mil. Eur or share under 49 percent</td>
<td>Notification</td>
<td>Decided by FDI screening authority</td>
<td>Decided by FDI screening authority</td>
</tr>
<tr>
<td></td>
<td>Critical infrastructure or SCFS</td>
<td>None</td>
<td>Request</td>
<td>Compulsory</td>
<td>Compulsory</td>
</tr>
<tr>
<td></td>
<td>Under 10 mil. Eur or share under 25 percent</td>
<td>Notification</td>
<td>Decided by FDI screening authority</td>
<td>Decided by FDI screening authority</td>
<td>May proceed with investment unless decided otherwise by the authority</td>
</tr>
<tr>
<td>From other countries</td>
<td>Critical infrastructure or SCFS</td>
<td>None</td>
<td>Request</td>
<td>Compulsory</td>
<td>Compulsory</td>
</tr>
<tr>
<td></td>
<td>Under 10 mil. Eur or share under 25 percent</td>
<td>Notification</td>
<td>Decided by FDI screening authority</td>
<td>Decided by FDI screening authority</td>
<td>May proceed with investment unless decided otherwise by the authority</td>
</tr>
<tr>
<td></td>
<td>More than 10 mil. Eur or share more than 25 percent</td>
<td>Request</td>
<td>Compulsory</td>
<td>Decided by FDI authority</td>
<td>Must wait for decision by FDI screening authority</td>
</tr>
</tbody>
</table>

Source: Author.

Application of principles in table 2 is based on the logic that increased risk of FDI shall be addressed by more detailed screening and stricter rules. Moreover, the above mentioned example does not include the investment possibility into the sector of defence and military which is usually based on bilateral treaties signed between governments and thus are not covered by this regulatory system.
Q6: Is there an EU (Community) dimension or EU interest?

Some acquisitions may have a communitarian dimension and fall under the rules of competition and anti-trust policy of the EU.¹ Thus some mergers may be subject of EC approval and thus will be decided by the EC. The proposed regulations give also to the EC certain powers to decide about FDI aimed at the projects of EU importance. These two scenarios shall be considered when designing a national FDI mechanism. However, national screening mechanism may run parallel to that of the EU or even in cooperation. Nevertheless, here the problem of agenda duplication shall be considered.

Q7: Shall there be sanctions for non-compliance?

A transparent system of sanctions together with the clearly defined powers of the authority conducting the FDI screening may help to improve the effectiveness of the system and add responsibility to the FDI applicant. However, severe sanctions may discourage some investors. There shall be a clear link between control mechanism and sanctions. The more control applied, the less sanctions are needed. In general, attempts to bypass the system or provide misleading or untrue information shall be considered as a serious offense which may lead to investment non-approval.

Q8: what support measures can be established?

There are several good examples such as prior certification of investors which can reduce the burden and make the work of FDI screening personnel easier and thus reduce the time necessary for issuing a decision. It is worth establishing some official forms (also in English) which will be available to the investor or to create an on-line registration system which will make work easier for both investor and the FDI screening authority. An on-line registration system used for statistical purposes and preparation for FDI request or notification shall be aimed at data gathering. While some data (basic statistical) may be public (for example as in Italy), other data shall be treated as confidential with restricted access. This on-line system may be accompanied by a helpdesk providing further information about investments in the country.

However, there are many other recommendations of a more general nature. For example based on the German and Finnish experience Eva Rytter Sunessen and Morten May Hans-

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¹ According to Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation) (Text with EEA relevance) Article 1 - Community dimension is where: (a) the combined aggregate worldwide turnover of all the undertakings concerned is more than EUR 2500 million; (b) in each of at least three Member States, the combined aggregate turnover of all the undertakings concerned is more than EUR 100 million; (c) in each of at least three Member States included for the purpose of point (b), the aggregate turnover of each of at least two of the undertakings concerned is more than EUR 25 million; and (d) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than EUR 100 million, unless each of the undertakings concerned achieves more than two-thirds of its aggregate Community-wide turnover within one and the same Member State.
en (2018) derived several measures which may limit the negative impact of FDI screening (Sunessen and Hansen 2018 p. 7):

1. Mandatory reporting which can spare the responsible authority the effort to identify cases but will come at the cost of the acquirer.
2. Long time limits for reopening screening can give acquirers an incentive to comply with the mandatory reporting, but high compliance may come at the cost of increased uncertainty for the acquirer due to the longer period where the file can be opened. However, a clear definition of scope for screening can reduce this uncertainty.
3. Standardisation can bring down the costs for the responsible authority and for the firm, may reduce delays and scope for discretion, which will reduce uncertainty.
4. Simple, predictable and transparent screening mechanisms can reduce uncertainty and compliance costs for the firms (especially the rules that make communication easier).
5. Treating all documents carefully and confidentially can reduce concerns on the side of the acquirer and speed up the process.

The above mentioned principles shall be interpreted in a country specific context and adapted to particular needs of the governments. However, the golden rule of regulation shall be maintained: too much regulation has negative effects and when there is weak regulation the effect is similar to no regulation. In other words, regulation must be well fitting, balanced, transparent and motivating.

5. CONCLUSION

The main aim of this article was to look at the EC FDI screening proposal in the context of the Europeanization concept. While the first chapter revealed the existing debate regarding FDI on the EU level and presented the EC proposal, the second part was aimed at revealing national mechanisms of FDI screening in order to answer two research questions defined as follows: (1) To what degree are existing aspects of Europeanization concept applicable to the FDI screening proposal? And (2) What is the level of the compatibility of the EC’s proposal with existing FDI screening mechanisms among EU member states?

From the bottom-up perspective the EC proposal of FDI screening is an attempt to develop further integration at the supranational level as it extends integration to a new area which was previously covered by 11 member states which differed in the scope of their own instruments. From the neo-functionalist perspective the FDI screening mechanism may be a good example of the spill-over effect when integration in one sector leads to integration in another. Moreover, the EC acted on the demand of some member states (Germany, Italy and France) who succeeded in uploading their issue at the EU level to address the need for further cooperation stimulated especially by Chinese investments. All three states, as explored in the second chapter, may be considered as “pace-setters” or leaders in the area
of FDI screening which is in line with Europeanization research (Börzel 2002 p. 196). For this reason the EC proposal for the FDI screening is a good example of the Europeanization attempt despite several problematic points which were mentioned especially within the British internal debate. Again it seems that some states will object to sharing confidential data at the EU level and will push for cooperation on a voluntary basis.

Regarding the second research question it shall be stressed that the EC proposal seems to be compatible with all reviewed national mechanisms for FDI screening. However, as aside effect of the EC proposals some cases subjected to FDI screening at national level might be extracted at the EU level. This might be in cases touching on important projects of EU interest according to article 3 of the regulation proposal. Nevertheless, this is not an objection for the compatibility. On the contrary, it seems that the EC proposal creates some minimal standard for countries lacking their own national mechanism and some sort of “superstructure” for those countries already operating a screening system at a national level.

The perspective from the second option implies that there is a certain misfit at the national level presented by a lack of a screening mechanism. However, this misfit has merely a latent form as the “superstructure” can operate without a national basis which will be made only by the “FDI Screening Contact Point”. Yet, the misfit may create a new pressure for adaptation. This is actually the case of the Czech Republic which is considering developing its own FDI screening mechanism, which again confirms to the Europeanization research regarding misfit (see Börzel and Risse 2000 p. 5). The requirement to create the FDI Screening Contact Points may serve as a cornerstone for new emerging national regulatory systems. For this reason it is positive that 11 countries in the EU have some experience with their national mechanisms and countries which build up new systems may learn from a variety of systems presented in the second chapter and build upon principles derived in the last chapter of this study which tries to contribute to the existing debate about FDI screening mechanisms.

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PUTTING THE ‘MENTAL’ INTO THE GOVERNMENTAL: HOW CAN NUDGES IMPROVE SHOCK COPING?

MARCO LEHMANN-WAFFENSCHMIDT1 AND BURAK ERKUT2

ABSTRACT

Nudging individuals towards improved decision making that serves their interest best is in vogue, not only among governments of the rich economies. It has also received growing interest from development agencies and development economists. Different experimental studies in developing countries have tested the impact of nudging on behavior. While these studies have mostly taken place on an empirical ad-hoc basis, our contribution proposes a theory-led reflection of the limits and potentials of nudging, with the aim to empower agents coping with external shocks such as droughts, floods, and earthquakes. We make use of Hayek’s cognitive theory to point out how behavioral mechanisms may respond to nudges, and address normative concerns.

KEYWORDS

Nudge, Behavioral economics, Hayek

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1. INTRODUCTION

Giving behavioral impulses to individuals in such a way that they can alter their behavior towards serving their own interests, also called nudging (Sunstein and Thaler, 2003; Thaler and Sunstein, 2003), is currently used by both governments of rich economies and in the context of developing countries. Whereas experimental studies focusing on nudging (e.g. Beaman et al., 2009; Duflo et al., 2011; Gauri, 2012; Luoto et al., 2014) have mostly taken place on an ad-hoc basis, no theoretical considerations have been made so far for the use of nudging to cope with external shocks. Especially due to the recent developments in neuroscience (Fuster, 2011), which show how individuals make decisions by generating patterns based on their previous experiences, the effectiveness of nudges can be discussed from a theory-led perspective.

In this contribution, we discuss the role of nudges in the context of development based on a short overview, wherein we focus on the kinds of decision-making problems in which nudging is potentially effective. Nudging has been designed for situations in which choice architecture influences decision-making. We reflect on appropriate applications of nudging against the background of the broader development discourse in general, and with respect to previous applications of nudges by development economists and practitioners. We argue that many of the problems people living under conditions of poverty and exclusion face when exposed to external shocks are contingent on their individual behavior and decision-making. Against this background, we sort out which kinds of nudging can potentially improve people's ability to deal with shocks. For this purpose, we make use of Hayek's (1952) cognitive theory and its empirical evidence (Fuster, 2011) as well as some recent theoretical developments from the field of evolutionary economics (Erkut, 2016a) to propose a taxonomy of strategies of nudging in the shock coping context, and the behavioral mechanism behind the knowledge generation processes of individuals based on shock coping.

Section 2 briefly introduces the idea of nudging, and presents some typical development interventions and studies that have attempted to measure and evaluate the effectiveness of nudges with respect to their ability to help people cope with shocks. Section 3 proposes a theoretical reflection of the conditions under which nudges may be effective and focuses on the importance of understanding the mechanisms underlying behavior and changes thereof. Section 4 focuses on the challengers of nudging and concludes the study with some recommendations.

2. NUDGING FOR DEVELOPMENT: A SHORT OVERVIEW

Nudges refer to “any aspect of the choice architecture that alters people’s behavior in a predictable way without forbidding any options or significantly changing their economic incentives” (Thaler and Sunstein, 2008, p. 6). Nudging aims to achieve a certain, desirable behavior, and yields behavioral impulses instead of monetary incentives or sanctions. These
impulses are called soft interventions, since they are not direct interventions into the decision making processes of human beings.

In the context of development, saving behavior is a topic which has been analyzed frequently from the behavioral perspective. Increasing savings means the smoothing of consumption in order to cope against shocks is faced by certain barriers such as transaction costs, lack of trust and regulatory barriers, knowledge gaps, social constraints and cognitive biases (Karlan et al., 2014). Two popular behavioral approaches that can be called soft interventions are financial reminders and financial education. Introducing people to money boxes with pre-defined targets increased saving behavior of poor people in Kenya, as it has been shown in a field research by Dupas and Robinson (2013). A field experiment by Bruhn et al. (2013) in Brazil targeted high school students’ financial knowledge and planning abilities, which have been altered by financial education as a nudge; Berry et al. (2015) reached the same desired behavior in Ghana. On the other hand, the field research by Rodriguez and Saavedra (2016) used cell phone messages as reminders to alter the savings behavior of low-income youth in Colombia. The authors found out that combining reminders with financial education messages did not increase savings of the target group, and explained this observation with proposing to focus on a more structured financial education approach and a more intensive delivery of the messages. Gertler et al. (2015) used nudges in health promotion campaigns in India, Indonesia, Mali and Tanzania to find out how investment in health products and their use can be increased beyond levels achieved through subsidization. The authors recognized the main problem to be open defecation, which could not be solved simply by encouraging people to build toilets, but also nudging them to use the toilets for defecation purposes. The authors suggest that nudges shall be combined with subsidy programs, and the intensity of nudges is decisive on altering human behavior regarding the solution of this problem. Luoto et al. (2014) also provided free, safe water products to households in Kenya and Bangladesh, and focused on the role of marketing messages to encourage the use of these products, which delivered positive results. Fuentes et al. (2017) employed the approach of informing workers on pension savings and forecasted pension income, where the distinction between two groups of workers was whether the messages they received were on their personal savings, or general information about the pension system. The authors found out that personalizing information increased the amount of savings significantly; however, they also noted that the effect of the nudge can be temporary, and needs to be combined with other elements. These field experiments did not modify choice options, but still had visible effects due to soft interventions.

To encourage private households in Japan to purchase earthquake insurance contracts, the authors Sato and Saito (2011) made a field experiment based on two surveys. The results of the initial survey highlighted the fact that the public earthquake insurance was not popular due to high premiums; in the latter survey, the authors added a hypothetical private earthquake contract to the choice menu, which had even more expensive premiums than the public earthquake insurance. This resulted in a change in behavior of survey participants; those who initially said that the public earthquake insurance was not affordable changed their mind and found it affordable. Another field experiment by Duflo et al. (2011)
focused on decisions of farmers to invest in and use fertilizers in Kenya. According to the authors, even though the advantages of using fertilizers are known to the farmers, and they planned to buy them in the future, the plan eventually changes in order to focus on consumption rather than investing in fertilizers. This is explained by the impatience of farmers, and that the timing of their decisions affected the change in plans. The field experiment, which delivered positive results by increasing the purchasing of fertilizers, offered farmers the chance to buy vouchers right after the previous season’s harvest, and the option of free delivery. A similar approach was observed in the study of Barrera-Osorio et al. (2011) in the context of conditional cash transfers for educational purposes in Colombia. With the aim of preventing dropouts from secondary schools and increasing matriculation at tertiary educational institutions, the field research, which delivered significant results, focused on changing the structure of the conditional cash transfers by paying these as a large lump-sum upon the decision of re-enrollment (Barrera-Osorio et al., 2011). Positive effects were observed especially for the students from the poorest households. A similar approach was employed by Benhassine et al. (2015), although the employed program was not a conditional cash transfer. With the target of increasing school attendance in Morocco, the field experiment involved an educational support program giving financial incentives to alter parents’ beliefs towards the importance of education, which increased school attendance of children. In comparison to the aforementioned experiments, these three field experiments involve interventions that altered financial incentives. Even though in these cases the nudges worked in the interest of the target group, and contributed to positive changes, the financial incentives played an important role in the setup of the experiments. Although altering financial incentives and beliefs does not strictly count as nudging, according to the definition provided by Thaler and Sunstein (2008), these field experiments count as further examples of the increased use of behavioral tools in the context of developing countries. Altogether, this short overview provides some basic characteristics of nudges that can be relevant for the context of shock coping.

In the context of developing countries, research frontiers are using randomized, controlled trials to test specific interventions and how they affect human behavior. The work of Abdul Latif Jameel Poverty Action Lab (J-PAL) has contributed to attempts of nudging in research. Bringing together nudging with the subjective well-being of human beings for policy designs in topics such as climate change, sustainable developments or malnutrition can be advantageous, especially since “behavioral interventions may reduce the individual capability to make critically reflected, autonomous decisions” (Binder and Lades, 2015, p. 23). For overcoming this issue, Binder and Lades (2015) proposed an autonomy-enhancing paternalism in order to improve the capabilities of individuals in making critically reflected decisions in their changed choice architecture, which aim to increase their individual welfare over time. As it has been shown in this short overview, the scientific debate is mainly driven by contextual, practice-based studies where the employed behavioral strategies may not always coincide with the original definition of nudging. Prior to the expiration of the Millennium Development Goals, Gauri (2012) made the contribution to increase the salience of development targets by introducing the concept of nudging. According to the
author, the notions to be considered during the formulation of development targets are ensuring that they are less cognitively demanding, more morally compelling, and that they utilize politically legitimate processes. Political institutions such as the Presidency of USA or the World Bank have developed their targets of improving the governance quality by using behavioral insights. Typical examples include human behavior on the issues of savings, health or consumption as well as tax and working ethics. The World Development Report 2015 on “Mind, Society, and Behavior” highlighted the importance of behavioral strategies in the context of developing countries. One point mentioned in this report is the use of mental models to interpret the world. The focus on mental models and perceptions of human beings is necessary in the development context, since knowledge generated in the minds of human beings is tacit and subjective in character, and it may not necessarily lead to rational behavior. This notion will be explained in detail in the context of the effectiveness of nudging.

3. EFFECTIVENESS OF NUDGING

3.1. IRRATIONAL BEHAVIOR

Individuals may behave in a non-rational way for a number of reasons. From the perspective of economics, the fundamental concept of homo economicus or the economic man is a basic way of understanding how the rational behavior shall look in a given decision situation. In reality, the individuals may – unlike the economic man – not act in a way which serves their interests, and at this point nudging can be a way of correcting this non-rational behavior. According to Thaler (2000), cognitive biases regarding human decision-making can be summarized with four different categories. These are: optimism/wishful thinking, overconfidence, the false consensus effect, and the so-called curse of knowledge. Optimism/wishful thinking and overconfidence are straightforward categories that need no further explanation. The false consensus effect can be summarized as the assumption that other people share the same beliefs as one’s self. On the other hand, the curse of knowledge is the tendency to believe that the knowledge possessed by one’s self is obvious to the others, whereas others may not even have heard of this particular knowledge. What these four categories share in the way they affect rational behavior is their occurrence as a result of the subjective character of knowledge, which is inevitable in a non-pre-determined economic environment. From the perspective of Hayek, “knowledge relevant for economic decisions exists only in a tacit form, and cannot, even in principle, be formalized in terms of explicit rules” (Hunt, 2007, p. 54).

Regarding shocks such as earthquakes or floods, risk-related human behavior can be generally explained in terms of the availability heuristic. Thaler and Sunstein (2008) said that the occurrence of a shock in the recent past can alter human behavior; therefore, human
behavior is biased on assessing the risk of the occurrence of a shock. Such misperceptions can be observed both on the individual level and on the governmental level, since “governments are likely to allocate their resources in a way that fits with people’s fears rather than in response to the most likely danger” (Thaler and Sunstein, 2008, p. 25).

3.2. A TAXONOMY OF STRATEGIES
Correcting this availability bias can be done by designing nudges to either increase the fear of a bad event (Thaler and Sunstein, 2008) and can be based on one of the following categories from Sunstein (2015):

A. Default Rules: A default rule can be generated e.g. for an insurance to natural disasters, which can automatically include all people.

B. Simplification: Complexity of bureaucratic procedures can be a disadvantage regarding coping with shocks. These can be reduced by simplifying the bureaucratic procedures that take precautions on the issue of shocks, in order to include people’s voluntary participation.

C. Uses of Social Norms: Informing people by focusing on the (desired) behavior of the majority can alter the behavior of human beings regarding a certain subject. For example, saying that “A vast majority of people living in floodplains are purchasing flood insurance for themselves” can be effective in increasing the number of human beings taking precautions by purchasing flood insurance.

D. Increases in Ease and Convenience: According to Sunstein (2015), reducing certain barriers can encourage human beings to act in a certain, desired way. Based on the example in C., it may not be enough to use social norms alone, but also support these with a bureaucratic easing of purchasing flood insurance, especially with emphasis on low cost options for the poor.

E. Disclosure: Disclosure can prevent ignorance and inattention (Sunstein, 2015). For example, mentioning costs of flood damage in the case of no flood insurance can also lead people living in floodplains to purchase flood insurance, as long as the numbers and data are taken from reliable sources.

F. Warnings, Graphic or Otherwise: Especially in case of populations with high rates of illiteracy, graphic warnings such as pictures can be used instead of written warnings, which can increase the awareness of the target audience. These can be either personalized or localized to the neighborhood/village.

G. Precommitment Strategies: Giving people the courage to engage in certain activities belonging to a target they want to achieve can be helpful in case of shocks. For example, using community-based support groups to overcome the damages caused by shocks can be encouraged, since these are often informally organized and very vulnerable in terms of their organizational structures.

H. Reminders: People tend to forget things – and especially in case of shocks, they associate their precautions to their past experiences. Lack of a past experience in case
of a shock can lead to forgetfulness in taking precautions. This can be changed by reminding people to take precautions.

I. Eliciting Implementation Intentions: Going to people and asking them simple questions that can activate their implementation intentions can be effective in coping with shocks.

J. Informing People of the Nature and Consequences of Their Own Past Choices: This can be more effective if there is a past experience of shocks.

As seen from these categories, there is no single way to formulate and implement an effective nudge. Rather, the effectiveness is contingent on the context of the designed nudge, on how this context is perceived by the initiators, and most importantly whether the perceptions of the initiators and those of the target audience match. This is the idea behind the matching of the perception/action cycles of the individuals (Fuster, 2011), for which the simplest example can be given as two individuals in a conversation – both having to understand what the other one says, processing it, and reacting to the statements in a proper way to keep up the conversation.

The idea behind Hayek’s (1952) cognitive theory states that “even the simplest form of sensation is based on prior experience” (Fuster, 2011, p. 6) i.e. when we are confronted with an event, our mind either associates it with experiences of the past that show a similar pattern to the current one, where “perception is made of relationships, history, and an ever-evolving cerebral cortex” (Fuster, 2011, p. 6). This pattern recognition is the starting point of the generation of new knowledge. With new knowledge, individuals use their capabilities to shape their environment with their actions. In the framework of Erkut (2016a) based on Hayek (1952) and Fuster (2011), the following nano-micro-meso-macro scheme can be used to identify at which stages of the perception/action cycle (illustrated in Figure 1) nudges can be effective:

1. Nano: Perceptions based on previous experiences. In case of an absence of a previous shock experience, nudges can be helpful to “substitute” for that previous experience in the human mind. In this case, the individual needs to associate himself with the “substituted” experience that nudging gives, i.e. identify one’s self in a shock situation. In case of the presence of a previous shock experience, nudges can activate that part of the memory to “remind” individual for taking precautions.

2. Micro: Generation of new knowledge. Individuals use the patterns recognized in their mind to generate new knowledge. Learnings from a shock are bound together with the contacts between neurons. This can be an association of the possibility of shocks based on either previous experiences or “substituted” nudging experiences, which can lead to a critical thinking and generating the tacit knowledge of taking precautions for shocks in the desired way, since human behavior is biased in assessing the risk of the occurrence of a shock.

3. Meso: Capabilities of individuals. Since generation of new knowledge is often not the only relevant factor for taking action, the capabilities of individuals need to be
heightened. A person noticing the danger of a possible earthquake, but not taking precautions because e.g. he finds the insurance very expensive (Sato and Saito, 2011), can be a problem where the individual does not have the capability to take action. A second issue arises for the ex-post shock coping mechanisms, being initiatives to cope with shocks, which can be vulnerable in their organizational structures. Instead of a top-down approach, nudges such as precommitment strategies can empower individuals for shock coping by addressing to develop their capabilities.

4. Macro: Sociotechnical Artefacts. The outcome of this perception/action cycle is the generation of sociotechnical artefacts, i.e. shock coping mechanisms on individual or societal level, which are “practices, representation and knowledge, emerging from the interdependencies between space, time and matter” (Pellegrino, 2014, p. 2). This is the observable phenomenon on the marketplace, but its emergence is necessarily based on the generation of individual knowledge by pattern recognition.

**FIGURE 1:** PERCEPTION/ACTION CYCLE OF A SHOCK-COPING INDIVIDUAL (SOURCE: OWN ILLUSTRATION BASED ON FUSTER (2011))

To summarize, the visible market outcome is an issue where nudging cannot be used, since it is only the outcome of the knowledge generation process of individuals. While understanding the processes is not usually the focus of research, it is important to mention that understanding, rather than simply changing behavior, is a pre-condition for generalizing knowledge gained through experimental studies (Grüne-Yanoff, 2015; Deaton, 2010). Hence, nano, micro and meso dimensions are the three dimensions that nudges can address, where the aforementioned taxonomy of strategies only focuses on the ideal-typical cases and not the practical use, which can involve combining different strategies depending on the context. In other words, it is a matter of degree.
4. POLICY RECOMMENDATIONS AND CONCLUDING REMARKS

Both from the practical and the ethical points of view, nudging receives criticism. Its employability is questioned on the issue of whether nudging can be effective forever, or if its effect disappears after a certain time. Gaudeul and Kaczmarek’s (2016) experimental evidence pointed out the fact that while a default based nudge was effective, it could not change the behavior of the participants. The authors found out that those who opposed the nudge were more motivated to show opposition over time than those who were initially influenced by the nudge. A possible reason for the justification of these findings is that nudging mainly influences those who are close to indifference between two alternate actions (Gaudeul and Kaczmarek, 2016). Hence, the effect of nudging can be limited to those who do not strongly oppose to a certain behavior.

From the ethical perspective, the discussions focus on the issue of on which normative ground behavior is allowed to be manipulated. Especially liberal positions criticize the fact that legitimacy is absent in this case. As it can be seen from the short overview of the literature, many behavioral approaches in the development context cannot be qualified as nudges, if we define nudge in terms of Thaler and Sunstein’s (2008) original definition. This is due to their attempt to intervene in human behavior e.g. with financial incentives. What we can learn, on the other hand, from Hayek’s cognitive theory (1952), and the empirical evidence supporting this theory (Fuster, 2011), is that neither the human mind, nor the market needs a central planner to generate new knowledge – hence; the spontaneous order is more than a metaphor. The challenging issue for putting the “mental” into the governmental is therefore the use of behavioral strategies that are enabling people to choose what is best for them, and not for the central planner. Rizzo and Whitman (2009) listed six forms of knowledge that are necessary for a decision maker to justify his nudging strategy. These are: the knowledge on the true preferences of individuals, understanding that a certain bias may differ across individuals, time and space, having extensive knowledge of self-debiasing measures of individuals, the ability to account for the interdependence of biases, and anticipating the decreasing self-regulation effect of paternalistic policies and possessing knowledge on these issues at the level of the whole population.

The basic concerns from the perspectives of ethics and governance are especially weak, because like any other laws, bids and bans nudges also serve a certain target, which is set by the initiators. Therefore, the criticism on the issue of absent legitimacy cannot be specific for nudging – the method is the only difference in laws, bids, and bans because of these three are normative stipulations given by parliaments, governments, police etc.; failure to comply with these are punished by sanctions. Nudging, on the other hand, works with behavioral impulses instead of monetary incentives or sanctions, which is described as “soft paternalism”. Of course, also nudges can be misused by means of deliberate manipulations (Akerlof and Shiller, 2015).

Observing nudging in the context of the “pretence of knowledge” leads one to notice that the critical points Hayek (1974) mentions are very relevant: First of all, the use of nudging
is necessarily involved with increasing the quality of life of certain groups of people. In this case, there may be variables that are non-measurable based on the conventional methods of economics, which may have an influence on how people perceive the quality of their lives. Categorizing a behavior as irrational, and proposing the alternative that is rational is challenging. Either by focusing on the subjective well-being of the individuals (Binder and Lades, 2015) or by using nudging for self-empowerment as a self-management tool (Erkut, 2016b; Kaya and Erkut, 2017), progress still is to be made in this issue.

Second, observing a certain complex behavior is not enough for designing a nudge; the complex behavior needs to be represented in a reduced form. As any evolving socioeconomic process has some predictable and some unpredictable components or variables, the focus can be put on the predictable variables, which can be done by analyzing the structural similarities of different evolving processes (Lehmann-Waffenschmidt, 2008). This method can be useful to capture some recurring patterns regarding human behavior and socioeconomic processes (Erkut 2016c). Third, predictions on the outcomes of nudges can be limited due to the complexity of human behavior. Some general pattern predictions can be made, but specific outcomes cannot be predicted.

Happiness research questions whether nudging can have a positive impact to the subjective well-being of humans. One emerging field of research related to happiness research sees nudges as behavioral strategies that can generate critical thinking, hence not only nudging an individual to fulfill a certain behavior, but also to critically think and question why he does it (Binder and Lades, 2015). Even though these new developments in the fields of behavioral and evolutionary economics are promising, a lot has to be done for the successful formulation and implementation of nudges without falling into the trap of the conventional strategies such as laws, bids, and bans. These discussions all address the fact that nudging is new in use and therefore subject to a number of concerns.

Certainly, nudges can be helpful in shock coping, when they are designed “carefully” – by considering aforementioned factors and by making a clear distinction between a soft intervention and a behavioral strategy altering financial incentives. These challenges are demanding ones, but putting the “mental” into the governmental is still possible – it only depends on the question “how?”, which must be answered by theoretical investigation, experimental tests, and political implementations.

REFERENCES


UNIVERSAL SUFFRAGE: THE CENTURY OF CORRUPTING INCENTIVES?

MOSHE YANOFSKIY\textsuperscript{3} AND SERGEI ZHAVORONKOV\textsuperscript{4}

ABSTRACT

Conflict of interest of welfare dependent voter creates wrong incentives. These incentives inherent to universal suffrage, yield consequences, as predicted by John Adams back in the 18-th century. Historically the rise of the modern welfare state might be traced to the emergence of mainstream left parties, which promoted government care “from the cradle to the grave”. This paper will address the damages to Democracy caused by conflict of interest, which led to irresponsible leadership and permanent peacetime budget deficit. Historical examples from the 1990s show possible escapes from the trap of universal suffrage.

KEYWORDS

Universal Suffrage, Conflict of interest, Left parties, Budget deficit, Regulations

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In Israel one third of the citizens pay taxes, one third are conscripted in the Army, and one third attend the Reservists’ Assemblies. The problem is - it is all the same one third

Israeli proverb

Then one with the plough, seven with spoon

Russian proverb

1. INTRODUCTION

A popular assumption holds that universal suffrage is inseparable from the institution of democracy. This view is broadly accepted as common knowledge and very few take the risk to challenge it. We, alternatively, consider the voting right a privilege not a natural right. Our view is not new: the founding fathers of the US considered taxpayers’ representation as a part of the social contract and fairly earned privilege. In general, during the age of classical liberalism the connection between payment of taxes and the representation in parliament seemed self-evident. For example, Adam Smith suggested establishing a quota for the colonies to resolve the conflict with them: the colonies would be represented in the British Parliament based on their contribution to general tax revenues. Taxpayers’ representation also became the preponderant motivating factor in the franchise extension reforms in Great Britain (1832 and 1867).

The following seems to be a reasonable reconstruction of the historical sequence of further events. The First World War (universal conscription) fueled the demand for universal suffrage. Great War impact played a pivotal role in women suffrage promotion in the heavy fighting Democracies. Unprecedented military efforts: men mass mobilization, rise in female labor participation, women broad participation in auxiliary military service con-

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5 In the modern context of extremely sophisticated taxation and government, taxpayers are those who pay the lion’s share of the aggregate tax burden. In more specific terms, we define taxpayer as a person who pays more taxes than receives from the budget.

6 ... Great Britain should allow such a number of representatives as suited the proportion of what is contributed in the public revenue of the empire, in consequence of its being subjected to the same taxes ... the number of its representatives to be augment as a proportion of its contribution might afterwards augment...’ See ibid, p. 482.

7 Poor men were forced to make a great contribution to the common good while not being represented in Legislature.
tributed to the adoption of the Canada Wartime Elections Act (September 20, 1917) and UK Representation of the people Act 1918 (February, 6)\(^8\).

Still based on the tradition of “taxation – representation” and on personal merits (with qualification) in 1918, franchise then became a so called ‘democratic right’. The emergency situation triggered empowerment of political forces and special interests, motivated to multiply the number of dependent voters willing to support bigger Government.

Universal suffrage, once adopted, ensured the rise of powerful leftist parties (see for example Matthew, McKibbin, Kay, 1976). Leftists in power caused the expansion of (“mandatory”) spending followed by peacetime budget deficits and a respective rise in public debt.

In this paper, “left” is defined as follows: parties or leaders that prioritize the provision of mixed public goods over pure public goods; those choosing “happiness promotion” instead of “just preventing evil”.\(^9\) Such parties and leaders promote government “from the cradle to the grave” and mock (since Ferdinand Lassalle) the “night-watchman state”.

The expansion of government liabilities led to problems with state finances: budgetary deficits, the onerous burden of state debt, and inflation, all sometimes beyond control. The phenomenon of a budget deficit at wartime was well known from the beginning of the history. A peacetime budget deficit is a rather new phenomenon which demonstrates a decreasing demand among voters for restraint. Taxpayers are a shrinking percentage of voters: the fiscal irresponsibility of welfare clients is natural, and such irresponsibility is not the only component of their opportunistic behavior (just the easiest to measure). Budget welfare dependent voters are not concerned too much with the morality of their elected representatives and are easily bribed (or even ready to surrender their franchise as show the examples below).

In this paper we use our dataset to revisit the hypothesis on dependency between public finances’ decay (specifically on the rise of the peacetime budget deficit) and universal suffrage. We also make an attempt to explain Universal Suffrage’s influence on regulatory burden and public morale.

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8 Political scientist Perley Orman Ray (1918) summarizes: ‘The greatest suffrage victory of all has come early in the present year (1918) and is directly traceable to the important part played by the women of the United Kingdom in the prosecution of the war’.

9 Like welfare payments, Education expenditures, Health expenditures, etc. The formula coined by W. von Humboldt (1792).
2. LITERATURE

2.1. RISE OF UNIVERSAL SUFFRAGE

Dahl (2000), Tilly (2007), Acemoglu and Robinson (2006) and many others categorically assert that no real alternative to universal suffrage can be found. Przeworski (2000) supports the same idea, albeit more cautiously. The principal argument of the above authors is essentially historical, that the population groups that had been historically denied the “right to vote” struggled and ultimately achieved this right.

Yet in a later work Przeworski (2009) suggests that frequently suffrage was granted by an “incumbent elite,” rather than fought for by groups deprived of power. The latter suggestion is confirmed by the chronological study of decisions to extend voting rights. This study indicates that with rare exceptions, the groups demanding suffrage posed no real threat of civil war or significant damage to the economy. The greatest likelihood of civil war arose in Great Britain on the eve of the Great Reform Act (1832). In this case, the threat originated from the wealthy industrialists (who demanded voting rights for themselves) rather than from poor workers or women.10 Lizzeri and Persico (2004) presented the rationale of ‘why an elite may want to expand the franchise even in the absence of threats’. The authors had focused on the Great Reform primarily. They stressed that franchise extension (to wealthy taxpayers, actually) and “rotten boroughs” privilege repeal caused a fall in “wasteful spending”, cuts in welfare spending and a rise in quality public goods provision.

The following interests supporting universal suffrage seems convincing:

1. Competition between parties for new potential voters.
2. Common interest of political parties as intermediaries between candidates and voters; growth of the number of voters essentially drives up demand for the party mechanism (Congleton, 2011 p. 176) both from voters searching for information on candidates and from candidates trying to reduce their electoral campaigns’ costs.

2.2 OUTCOMES OF UNIVERSAL SUFFRAGE INTRODUCTION

Peacock and Wiseman stressed the sustainably low level of UK governmental spending during XIX century (Peacock, Wiseman, 1961, p. 36). They posed, among the objectives of their study, to explain the expansion of the government scope and public spending by the change of voters’ preferences. The authors, however, did not even mention Universal Suffrage introduction as a factor of drastic change in the public spending trend since WWI.

Robert Barro (1979) showed wartime deficit increase and close-to-zero overall deficit between 1866 and 1916. He stressed the wartime increase in deficit but nevertheless consid-

10 The only large-scale incident known to the present authors took place in 1841 at Rhode Island (the so called Dorr war). The attempted uprising did. The uprising impacted increasing the number of voters in 1843, despite the fact that the 1843 State Constitution extended suffrage based on a taxpaying voting qualification requirement: “all taxpaying native-born adult males.”
ered the deficit as a kind of natural phenomena. Perception of moderate peacetime budget deficit (below 3% of GDP) and public debt (below 60%) as a kind of “natural calamity” becomes standard in the modern studies (see for example, Ide, Park, 2015).

While Universal Suffrage as a factor of public spending growth is not yet fully explored in the literature, some authors already try to explain governments’ expansion by choice of the newly enfranchised voter.


A sub-national government case study (Saxony, 1896-1909) shows a similar effect. Suffrage extension in 1909 had negative effects on the stock market (Lehmann, Hauber, Opitz, 2012). The effects were measured through stock market prices of Saxon firms listed on the Berlin stock exchange. The same factor accounts for public sector growth (Boix, 2001).

Based on the surveyed sources, we suggest the existence of a link between growing (even at peacetime) public debt, chronic budget deficit and inflation and the universal suffrage. It seems logical that in democratic states (where the voting right is real) the principle of universal suffrage yields a multitude of incentives for opportunistic behavior. We are going to verify the above hypothesis with both qualitative and quantitative analysis.

Universal suffrage begot powerful leftist parties. The leftists started generous spending to care about everyone. Generous spending caused the peacetime budget deficit. War’s responsibility for deficit is obvious, while economic crisis, recoveries and booms lose their significance as a budget deficit explanation (compare with Barro, 1979; Barro, 1986) as soon as Taxpayers Democracy epoch data is included in the sample (See statistical Analysis below).

Sorrentino (1983) pointed out the trend of a decrease in males’ participation in labor force, simultaneously with the female’s participation increase. The simplest interpretation is that “cradle to grave” government causes the gradual deterioration of the male labor ethic. Deteriorating family responsibility and declining breadwinner’s duty discourages man to work. Female employment reflects the growing uncertainty of women within the family and a generally weakened family institution (Shestakov, Yanovskiy, 2013; Yanovskiy, Shestakov, 2017).

11 They developed the theoretical model; all further mentioned papers are empirical studies.
12 Chilean researchers (Bravo-Ortega, Eterovic, Paredes, 2014) present findings which challenge the above mentioned conclusion. We think that the dataset used by Chilean colleagues is not suitable for the case: 46 countries, most of which never experienced taxpayers’ democracy. Women “married with the state” (not married, never married, single mother heavily depended on budget) are natural clients of the welfare state and naturally interested in big government instead of small limited government (Shestakov, Yanovskiy 2017)
2.3. CONFLICT OF INTEREST: INCENTIVES AND CONSEQUENCES

Voters, who benefit by the redistribution of taxpayers’ money, are in the position of a conflict of their personal interests with the public good (balanced budget, limited government, etc). Below we list some such interest groups.

A large and growing group of voters is made up of bureaucrats, other public servants (Buchanan, 1975[13]) and “professional” welfare recipients. Bureaucrats are interested in maximizing spending (Tullock, 1965, Niskanen, 1971) and obtaining more discretionarly power, excessive authority (Jasay, 1985). Some entrepreneurs obtain their principal income from the government by providing goods and services for state needs (sometimes through the extraordinarily fortunate sequence of won tenders). Public mass-media and public education employees interested in obtaining their budgetary “fair share” both reliably and independent of the quality of the work performed. They enjoy privilege and opportunities (funded by taxpayers) to influence elections’ outcomes. They participate in elections to impose higher taxation and restrict political and media competition. Finally, in many countries a large group of immigrants arrive with the expressed purpose of receiving welfare (Borjas, 1999; Hansen, Lofstrom, 2009; Azarnert, 2010).

The above listed groups (and the list is far from complete) tend to force taxpayers to pay for their existence ‘for the sake of the public good’ supported by the claim of a ‘moral duty to help.’ This claim is poorly reasoned (private charity spends every dollar of aid better than government - Edwards, 2007). This claim is even less well reasoned regarding those who can work and earn and are responsible for their dire condition (Spencer, 1884). The real reasons for such “generosity” are easily explained by the interest of the increased number of voting recipients of mixed public goods and welfare. Smith (1980) considered the absence of such a tax-extorting coalition and modeled financing of public goods. He concluded that taxpayers are capable of developing a private mechanism (agreement) for financing even pure public goods. Our present suggestions do not go this far.

Universal suffrage opens the door for bureaucrats to capture the government, building a political machine driven by electoral clientelism and vote-buying. Dependent clients fail to be the rational, sensible agent (Somin, 2013), capable of bearing responsibility for his actions and resolving the disputes under simple and transparent rules instead of relying on excuses and exemptions. So “impartial administration of Justice” without “indulgence to poor man” is not enough for him14.

Thus bureaucrats are being empowered to extort taxpayers’ money, escalating taxes to fund state expenditures. The volume of mixed public goods provided by the state has risen sharply since universal suffrage was introduced. And historical statistics of the dynamics of

13 Chapter 7, para 9.36
14 That is why universal suffrage regularly fails to meet Adam Smith’s simple preconditions of prosperity: “... easy taxes, and a tolerable administration of justice…” (Lecture in 1755, quoted in: Dugald Stewart, Account of the Life and Writings of Adam Smith LLD, Section IV, 25. http://www.econlib.org/library/Smith/smWN0.html. See also: Adam Smith, The Wealth of Nations, Chapter V of Book IV).
state debt and inflation leads to the same conclusions. Before universal suffrage, budgetary problems were almost exclusively due to military shocks or other exogenous upheavals of a similar magnitude. In the era of universal suffrage, a budget deficit, growing state debt, and inflation became the norm.

Introducing universal suffrage lowers the civic competence, skill, and overall quality of the voter, making voters on average considerably more dependent, less educated, less experienced in life, etc. (Somin, 2013). Individual voters’ irresponsibility yields national financial irresponsibility: new voters do not demand government live within its means and balance the budget because to them the main criterion of success is the scale of redistribution and personal access to its results (Hoppe, 2001, pp. 29-33; 55-98 etc). A property-related or tax-related qualifying requirement does not deprive people of their democratic rights, but rather creates an additional stimulus to achieve economic self-sufficiency (Przeworski, 2010, p.75).

A tremendous increase in legislative action in old democracies must be emphasized (the problem addressed by Hayek, 1982), as parties “vied for the support of the new working-class voters by enacting legislation to buy their votes” (Green, 1993, p. 15).

Introducing universal suffrage has led to drastic growth in state expenditures (Aidt et al., 2006, Funk and Gathmann, 2006, Tavares and Wacziarg, 2001). Tavares and Wacziarg (2001) even argue that modern democracy in general has a negative impact on economic growth.

2.4. REDISTRIBUTING THE WEALTH, EXPANDING SCOPE OF GOVERNMENT

Growth of state expenditures took place thanks to redistribution programs and programs for providing “mixed” public goods (education, health, and, to a lesser extent, projects in infrastructure, science, culture, and so on).

Boix (2001) stressed that public sector expansion is a feature immanent to modern democratic regimes with “high participation” (which he equates with universal suffrage). He shows that the public sector burden is minimal under “low participation” democracy, the heaviest under “high participation” democracy and intermediate under autocratic government.

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16 The paper deals with a shorter period: 1970-89, working with more detailed specifications of channels of influence upon growth. The magnitude of state consumption is among the influence channels of this kind, having an obvious and significant impact upon growth rates. At the same time, the magnitude of state consumption is positively and statistically bound up with democracy in a significant way (see Table 10 on p. 1371). Przeworski et al. (2000) reach somewhat more optimistic conclusions based on 1950-90 data.

17 The case, actually described by Lizzeri and Persico, 2004.
A growing body of empirical studies provide evidence of positive correlation between public spending and per-capita GDP which is consistent with the so-called Wagner’s law (Lamartina, Zaghini, 2011).

Introducing universal suffrage weakened safeguards of private property (Acemoglu, Robinson, 2006) as feared by Aristotle (who warned against “ochlocracy” – the sort of the “mob rule”) and conservative-minded Founding Fathers like Madison and Adams. The latter wrote: “Perhaps, at first, prejudice, habit, shame or fear, principle or religion, would restrain the poor from attacking the rich, ... but the time would not be long before courage and enterprise would come, and pretexts be invented ... taxes laid heavy on the rich, and not at all on the others; and at last a downright equal division of every thing be demanded, and voted” (“Defense of Constitution...”).

Some modern cases prove that “prejudice, habit, shame or fear, principle or religion” do not always restrain people even for the time being. In many cases we see a “one man, one vote, one time” phenomena: in countries without a democratic tradition, universal suffrage often brings to power despotic regimes that abandon any kind of democracy (so that voting becomes a “one-time” act). This experience by itself should raise grave concerns about the sustainability of democracy under universal suffrage (see for example Blaydes, Lo, 2012). For the appropriate survey, see Przeworski (2010), pp. 80-84. In his essay on “The Law”, Frederic Bastiat (1850) presented universal suffrage as one of the ways to introduce “legal plunder” (pp. 6-7)20. John C. Calhoun warned of the nation’s dividing into taxpayers and tax spenders (Calhoun 1811/1992; Lipford, Yandell 2011). His prediction is now coming true, though the private property institution is not yet completely destroyed (as Karl Marx hoped).

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18 The Federalist No. 10: “Hence it is that such democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property ... Theoretic politicians, who have patronized this species of government, have erroneously supposed that by reducing mankind to a perfect equality in their political rights, they would, at the same time, be perfectly equalized and assimilated in their possessions, their opinions, and their passions.”

19 Besides danger of incentive to redistribute, Adams addressed the voters’ qualification issue, the problem of the lack of a dependent person’s capacity to make responsible decisions (Letter to James Sullivan, 1776).

20 Knut Wicksell was concerned about a different risk: the likelihood that well-to-do voter taxpayers would be able to transfer part of their expenditures onto the shoulders of poor taxpayers, using their political preponderance for leverage (Blankart, Fasten 2013). However, we failed to find an actually realized historical pattern reproducing “legal plunder” of the poor and disenfranchised taxpayers by their rich fellow citizens.
3. SOME OF VOTERS’ INCENTIVES, TYPICAL FOR SELECTED SOCIAL GROUPS

3.1 INCENTIVES OF THE VOTER-TAXPAYER

Taxpayers hate to waste money. Extensive discussion on the expedition against Tripoli pirates at the turn of 18th century lasted for many years (London, 2005). The government control programs and resource mobilization in the US after WWI were abandoned, proving the relative strength of taxpayers’ incentives even after the transition to universal suffrage in the USA.

3.2. CIVIC BUREAUCRATS’ INCENTIVES

Civil officials’ utility depends on the managed budget size (share) – pointed out initially by William Niskanen (1971). We believe that the discretionary powers are principal component of bureaucrats’ utility too (de Jasay, 1985). Therefore a conscientious and enlightened official should submit a statement about conflicts of interest, and abstain from voting until retirement or demotion.

The lifetime utility of a bureaucrat depends on his (her) tenure. All components (tenure, budget and discretionary powers) heavily depend on two institutions: civil service autonomy and universal suffrage. Civil service autonomy pushes up tenure, and universal suffrage drastically extends non-military spending (Aidt et al, 2006; Yanovskiy, Zatcovetsky, 2017). Both long-lasting tenure and budget-dependent voters’ political power increase bureaucrats’ opportunity to obtain greater discretionary powers. Several cases of voting behavior of budget-dependent voters are discussed below. The Niskanen model predicts bureaucrats’ strong support for the party of generous spending and “cradle-to-grave” care.

A clear example of the bureaucracy’s interference in the electoral results can be seen in the attempt of the Works Progress Administration to recruit voters among the clients in 1938.21 The Hatch Act addressed this very problem.

Bureaucrats emerged as staunch fighters against private discrimination (see for example the Federal Contract Compliance manual 22). The enforcement of anti-discrimination legislation is widely deployed against private entities for two principal ends: to severely restrict freedom of contract and to promote the special interests of groups that predominantly vote for the Nanny state and Big Government (see for more details paper Yanovskiy, Zhavoronkov and Zatcovetsky, 2015).

21 http://www.us-history.com/pages/h1599.html For more data and examples of civil service use for electoral ends see Folsom, 2008.

3.3. WELFARE BENEFICIARIES’ INCENTIVES

This large and growing group of voters consists of “professional” recipients of welfare. It seems evident that persons whose interests include the redistribution of the taxpayers’ money in their own favor have no moral right to make decisions by voting in elections. This applies in part also to those entrepreneurs who derive most of their income from the state budget. “Destigmatization” of welfare reception was detected in the USA by the early 1980’s (see for example, Loewenberg, 1981).23

The infamous NGO ACORN, which heavily relied on budget support, was rather sincere about its moral constraints: “The broad vision of ACORN as a movement to unify the powerless in pursuit of economic justice was not shared by all the members... to become a force for social justice in America.”24

ACORN’s important mission was to encourage tax-spenders to vote. Voting privileges for the dependent and the very idea “you are entitled to social welfare” promoted by tax-spenders’ political parties (the leftists) explain the destigmatization of welfare reception process25.

Voters of Detroit and New Orleans support their mayors even after catastrophic failures. New Orleans mayor Ray Nagin was successfully re-elected in 2006 after his failure to provide relief after Hurricane Katrina (2005).

Detroit mayor Kwame Malik Kilpatrick was successfully re-elected in 2005 after numerous scandals26 (McGraw, 2008). The mayor’s reelection was heavily supported by the budget-dependent citizens.

Federal Judge Alcee Lamar Hastings was impeached in 1988-89 after he was found guilty27 in bribery and perjury.28 Nevertheless he was elected (re-elected) 11 times as a US Congress representative since 1992 (Democrat, 20th congressional district, Florida).

Voters’ low sensitivity to a politician’s moral standard, as detected in the last third of the 19th century could be explained as an aftermath of the US Civil War.29 Ideologically motivated volunteers of both armies - “the natural aristocracy”, public morality keepers -

23 For more details and sources see Supplemental materials, section 6.
24 http://www.acorn.org/early-growth.html?id=12342 retrieved July 21 2013; See the same: Power to the People: Thirty-five Years of Community Organizing http://www.sonoma.edu/users/w/wallsd/community-organizing.shtml. To provide the reader due translation the term: “Social Justice” (tracing from Russian expression “socialnaya spravedlivost’, as in Russian very word “spravedlivost” – “justice” is broadly understood as relating to redistribution “to benefit poor”), this statement to some extent reminds us of the standard Conflict of Interest Statement “I have involvement, affiliation and financial interest...” with an inverted conclusion: “so I determined to vote, though my personal interest dominates the common goods’ considerations.”
26 http://www.freep.com/article/20080905/NEWS01/809050448/The-rise-fall-Kwame-Kilpatrick
29 By the way, the war almost coincided with universal (white) male suffrage that came into effect by 1860.
suffered disproportionately high casualty rates during the War. Modern peacetime offers no satisfying explanation other than reduced incentives of the historically-new voters to supervise their representatives. The latter is perfectly rational if representatives are considered as lobbyists for additional voter income, taken from someone else’s pocket.

Taxation rate sensibility for this group turned out to be insignificant; at least we failed to find such evidence while exploring the electoral history.

There are lots and lots of similar cases. It’s true; one could find a number of opposite examples too. One would fail to find a significant number of examples of irresponsible voters’ behavior under Taxpayers’ Democracy (to say nothing of the multiple scenarios of voters surrendering their suffrage). That shows us the crucial difference between the institutions.

3.4. DEMOCRACY BETRAYED BY VOTER

In the era of the universal suffrage a phenomenon of mass voting for anti-democratic parties emerges. We actually witness voting for the abolition of democracy per se.

We observed it in Weimar Republic during the elections in the 5th, 6th and 7th Reichstag (last free elections took place in 1930-32). Then, 31%, 52% and 50% of voters respectively voted for openly totalitarian parties: communists and Nazis.

During Reconstruction, a sizeable share of black voters turned to be uninclined to preserve their franchise and essentially sold their votes, paving the way to the 1877 Compromise commonly blamed for disenfranchising free men (Woodward, 1991, p.15531). These black voters easily gave up their franchise since people tend to value free goods pretty low. Such low-valued goods (suffrage not backed by the paying of taxes) can be easily exchanged for just a promise of all-encompassing lifetime care or even of national prestige. On the other hand, we have never observed voluntary suffrage given up by those who paid for it.

The above mentioned conflicts of interest and opportunities to use public funding for the consolidation of political support for big government (Jasay, 1985) resulted in the following gradual substitutions, plaguing the family, harming society and spoiling the government:

Independent breadwinner, earner and tax-payer is substituted by welfare taker and tax-spender;

Generous philanthropists are substituted by “Generous” government (Hungerman, 2005; Hungerman, Gruber, 2007; Edwards, 2007);

30 http://www.gonschior.de/weimar/Deutschland/index.htm

31 Liberal C. Vann Woodward (1991, p.16) wrote: “… The reformers, offended by the Carpetbaggers’ record of corruption, did not stop to ask who bribed the Carpetbaggers, nor did they stop to reflect that the New York legislature, which had no Negro and Carpetbagger members, had probably been during the Reconstruction period as corrupt as any state legislature in the South.” Carpetbaggers’ corruption, supported by 700,000-strong corps of new voters, was taken by Woodward for granted.

32 See above for more cases (one man, one vote, one time).
Responsible spouses and parents are substituted by governmental social workers (Shestakov, Yanovskiy, 2013; Yanovskiy, Shestakov, 2017); military leaders are substituted by military lawyers (Yanovskiy, Zatcovetsky, 2017).

4. STATISTICAL ANALYSIS

4.1. DATA AND VARIABLES

Data: for the data detailed description and sources see Supplemental materials pp. 33.

Sample: the countries that experienced Taxpayers’ Democracy (competitive elections with voters’ qualification): Austria, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, UK, USA. Observation period: 1791-2011. An Observation period provides the opportunity to compare institutions of taxpayers’ democracy with universal suffrage democracy.

Government finances variables: Budget Deficit, Inflation (CPI - consumer price index) - national statistics; Spending to GDP.

Universal Suffrage / Taxpayers’ Democracy (ordered categorical variable): “-1” qualified voters only; “0” male suffrage; “1” universal suffrage.

Regulatory burden measured by modified index of freedom from regulation (Historical Index of economic Freedom, - De La Escosura, 2015) – see for details Supplemental materials;

Wars: great wars dummy (World Wars and Civil War for the USA, 1919 and 1946 included), local wars dummy (binary variable).

Religion: protestant or catholic (binary variable). We marked country as protestant or catholic based on historical tradition.34

Leftist electoral support measures share of votes for the parties, which promote “cradle to grave” care (see definition above). Elections to the parliament lower chamber are considered.

Political system variables: Federation: dummy variable for federate states. Public Media (binary variable: “1” if public media like TV or radio historically dominate in political news and events coverage.

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34 Austria, Belgium, Italy, France were marked as catholic; Canada, Denmark, Germany, Netherlands, Sweden, Switzerland, UK, USA – protestant; Japan – neither catholic nor protestant.
To manage the missed values (data) problem, an additional dataset with imputed data (see Supplemental Materials) was created. The regressions’ outcomes turned out to be almost the same as before imputation.

### 4.2. Statistical Tests

In this section we performed statistical checks for the dependence of budget deficit and inflation on universal suffrage, wars and economic crises.

For this article we opted for a two-step identification strategy. First we identified several relationships of interest between budget deficit, inflation and left-wing voting with variables that might historically be at work in causing them, so the correlation should be present in the data. Then we estimated these relationships with ordinary least squares (OLS) method and by panel regressions. Special attention was paid to how coefficients will be affected if unobservable heterogeneity is taken into account (as for time and countries). For each relationship we estimate pooled OLS, fixed effect and random effect panel regressions. That gives us a possibility to fit the best model in each case with Hausman (1978) test. Panel regressions usually yield more robust results than pooled OLS.

On the side of results we can see that political variables such as universal suffrage and power rotation are doing great job in explaining such economic outcomes as budget deficit or inflation. All main variables of interest are significant and have the expected sign: rise of universal franchise extends left-wing voting and on average increases the deficit, although large country effects suggest that there are considerable variations among the national systems. We also have some expected results with dummies, such as involvement of a country in one of the Great wars increasing its deficit. Federation decreases government deficit, which is somewhat at odds with the booming research of economic implications of constitutions (Persson and Tabellini, 2005).

In Table 2 estimation results are shown for the statistical link between universal suffrage and budget deficit (in Table 1 – indirectly) with the list of different variables possibly contributing to the amplifying state expenditures. We controlled for wartime periods, religious tradition (catholic / protestant countries), legal tradition (civil law). The link remains significant and positive. Similar results were achieved when controlling for federation or government involvement into big infrastructure projects.

The story is pretty simple.

- Universal suffrage begot leftists: Leftists= f(UniSuffr).
- The leftists started generous spending to care about everyone: Spend_toGDP = f(Leftists).
- Generous spending caused peacetime budget deficit: Leftists= f(UniSuffr); Spend_toGDP = f(Leftists) DefCentrGov=f (Spend_toGDP)

35 See Supplemental Materials for the data description details, for the summary statistics and for regression recount with imputed data – section 6.
TABLE 1. THE WAY FROM UNIVERSAL SUFFRAGE TO THE PEACETIME BUDGET DEFICIT

TABLE 1.1.

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Leftists (1; 2)</th>
<th>Spending to GDP (3; 4)</th>
<th>Budget deficit to GDP (5; 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OLS (1)</td>
<td>OLS (2)</td>
<td>OLS (3)</td>
<td>OLS (4)</td>
</tr>
<tr>
<td>Universal suffrage</td>
<td>16.9***</td>
<td>8.5***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.26)</td>
<td>(0.4)</td>
<td></td>
</tr>
<tr>
<td>Leftists</td>
<td></td>
<td>0.41***</td>
<td>0.14***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.012)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>Spend_toGDP</td>
<td></td>
<td></td>
<td>0.156***</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.017)</td>
</tr>
<tr>
<td>Public Media</td>
<td>16.9***</td>
<td>12.1***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.82)</td>
<td>(0.8)</td>
<td></td>
</tr>
<tr>
<td>Civil Law</td>
<td>10.2***</td>
<td></td>
<td>−4.85***</td>
</tr>
<tr>
<td></td>
<td>(0.63)</td>
<td></td>
<td>(0.49)</td>
</tr>
<tr>
<td>Federal State</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Great War</td>
<td></td>
<td></td>
<td>15.2***</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(1.8)</td>
</tr>
<tr>
<td>Local war</td>
<td></td>
<td></td>
<td>0.76**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.33)</td>
</tr>
<tr>
<td>Neutral</td>
<td>16.5***</td>
<td>10.9***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.237)</td>
<td>(0.3)</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>12.3***</td>
<td>−1.37***</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.3)</td>
<td>(0.27)</td>
</tr>
<tr>
<td>Const</td>
<td>16.5***</td>
<td>3.5***</td>
<td>−1.9***</td>
</tr>
<tr>
<td></td>
<td>(0.237)</td>
<td>(0.42)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>Number of obs.</td>
<td>2020</td>
<td>1678</td>
<td>1548</td>
</tr>
<tr>
<td>Adjusted $R^2$</td>
<td>0.568</td>
<td>0.343</td>
<td>0.14</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1  Robust errors in parentheses

Regressions presented at the Tables 1.1 and 1.2 test Hypothesis 1. Left parties’ successes are well explained by the introduction of the universal suffrage and the public media activity. As public media activity is a clear example of mixed public goods provision and prioritizing care over defense, public media left (“liberal”, “progressive”) bias looks quite natural.
Regression outcomes show that the public media could contribute to the sustained leftists’ success.

**TABLE 1.2.**

<table>
<thead>
<tr>
<th></th>
<th>Dependent variables:</th>
<th>Leftists (1; 2)</th>
<th>Spending to GDP (3; 4)</th>
<th>Budget deficit to GDP (5; 6)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>FE</td>
<td>FE</td>
<td>FE</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>Universal suffrage</td>
<td></td>
<td>16.3***</td>
<td>9.2***</td>
<td>0.26***</td>
</tr>
<tr>
<td>(0.25)</td>
<td>(0.36)</td>
<td></td>
<td></td>
<td>(0.02)</td>
</tr>
<tr>
<td>Leftists</td>
<td></td>
<td>0.51***</td>
<td>0.19***</td>
<td>0.15***</td>
</tr>
<tr>
<td>(0.014)</td>
<td>(0.01)</td>
<td></td>
<td></td>
<td>(0.01)</td>
</tr>
<tr>
<td>Spend_toGDP</td>
<td></td>
<td>15.4***</td>
<td>0.19***</td>
<td>0.15***</td>
</tr>
<tr>
<td>(0.6)</td>
<td>(0.01)</td>
<td></td>
<td></td>
<td>(0.01)</td>
</tr>
<tr>
<td>Public Media</td>
<td></td>
<td>10.8***</td>
<td>16.6***</td>
<td>15.5***</td>
</tr>
<tr>
<td>(0.8)</td>
<td>(1.2)</td>
<td></td>
<td></td>
<td>(0.6)</td>
</tr>
<tr>
<td>Great War</td>
<td></td>
<td>16.6***</td>
<td>15.5***</td>
<td></td>
</tr>
<tr>
<td>(1.2)</td>
<td>(0.6)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local war</td>
<td></td>
<td>1.02**</td>
<td>1.52***</td>
<td></td>
</tr>
<tr>
<td>(0.47)</td>
<td>(0.40)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neutral</td>
<td></td>
<td>1.52***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.40)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Const</td>
<td></td>
<td>16.7***</td>
<td>11.3***</td>
<td>8.6***</td>
</tr>
<tr>
<td>(0.2)</td>
<td>(0.3)</td>
<td></td>
<td></td>
<td>(0.33)</td>
</tr>
<tr>
<td>Number of obs.</td>
<td></td>
<td>2020</td>
<td>2020</td>
<td>1678</td>
</tr>
<tr>
<td>R² (overall)</td>
<td></td>
<td>0.568</td>
<td>0.681</td>
<td>0.343</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1 Robust errors in parentheses

Wars and (eventually) universal suffrage are bad for budget.
<table>
<thead>
<tr>
<th>Dependent variable: Budget deficit to GDP</th>
<th>OLS (1)</th>
<th>OLS (2)</th>
<th>FE (3)</th>
<th>FE (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal Suffrage</td>
<td>0.754*** (0.119)</td>
<td>0.647*** (0.120)</td>
<td>0.854*** (0.125)</td>
<td>0.555** (0.220)</td>
</tr>
<tr>
<td>GDP per cap. Growth rate, %</td>
<td>0.031 (0.056)</td>
<td>-0.029 (0.058)</td>
<td>0.020 (0.021)</td>
<td>-0.036 (0.068)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.347 (0.225)</td>
<td>0.697*** (0.070)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neutral</td>
<td>0.485** (0.186)</td>
<td>0.855** (0.321)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Great Wars</td>
<td>17.424*** (1.911)</td>
<td>16.627*** (2.158)</td>
<td>17.386*** (0.571)</td>
<td>16.677*** (3.469)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>1.062** (0.395)</td>
<td>1.061** (0.402)</td>
<td>1.357** (0.434)</td>
<td>1.288** (0.602)</td>
</tr>
<tr>
<td>Japan dummy</td>
<td>-6.314*** (0.628)</td>
<td>-6.504*** (0.755)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civil Law</td>
<td>1.362*** (0.204)</td>
<td>1.161*** (0.246)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Religion</td>
<td>-0.263 (0.290)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Const</td>
<td>0.157 (0.173)</td>
<td>0.570 (0.378)</td>
<td>0.528** (0.173)</td>
<td></td>
</tr>
<tr>
<td>Number of obs.</td>
<td>1669</td>
<td>1518</td>
<td>1669</td>
<td>1518</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.420</td>
<td>0.401</td>
<td>0.340</td>
<td>0.354</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1  Robust errors in parentheses

36 For the same regressions on different datasets (Dataset containing imputed values and Dataset, where “Universal Suffrage” variable value for 1921-1963 is “0” instead of “1” because of censuses in the Southern (Dixie) states, see Supplementary Materials, Tables A1 and B1 respectively.
### Table 3: Taxpayers Democracy Hampers Budget Deficit and Governmental Spending Growth.

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Budget deficit to GDP (1, 3)</th>
<th>Government Spending (2, 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OLS</td>
<td>OLS</td>
</tr>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td></td>
<td>FE</td>
<td>FE</td>
</tr>
<tr>
<td></td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td><strong>Taxpayers Democracy</strong></td>
<td>$-0.0745^{***}$</td>
<td>$-7.75^{***}$</td>
</tr>
<tr>
<td></td>
<td>(0.121)</td>
<td>(0.25)</td>
</tr>
<tr>
<td><strong>GDP per cap. Growth rate, %</strong></td>
<td>0.014</td>
<td>0.005</td>
</tr>
<tr>
<td></td>
<td>(0.055)</td>
<td>(0.02)</td>
</tr>
<tr>
<td><strong>Neutral</strong></td>
<td>0.57**</td>
<td>$-7.97^{***}$</td>
</tr>
<tr>
<td></td>
<td>(0.19)</td>
<td>(0.49)</td>
</tr>
<tr>
<td><strong>Great Wars</strong></td>
<td>18.5***</td>
<td>14.6***</td>
</tr>
<tr>
<td></td>
<td>(1.92)</td>
<td>(2.6)</td>
</tr>
<tr>
<td><strong>Local Wars</strong></td>
<td>1.12**</td>
<td>1.4***</td>
</tr>
<tr>
<td></td>
<td>(0.38)</td>
<td>(0.4)</td>
</tr>
<tr>
<td><strong>Japan dummy</strong></td>
<td>$-6.26^{***}$</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(0.63)</td>
<td></td>
</tr>
<tr>
<td><strong>Civil Law</strong></td>
<td>1.37***</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>(0.19)</td>
<td></td>
</tr>
<tr>
<td><strong>Const</strong></td>
<td>0.14</td>
<td>19.2***</td>
</tr>
<tr>
<td></td>
<td>(0.17)</td>
<td>(0.28)</td>
</tr>
<tr>
<td></td>
<td>0.61***</td>
<td>18.8***</td>
</tr>
<tr>
<td></td>
<td>(0.17)</td>
<td>(0.37)</td>
</tr>
<tr>
<td><strong>Number of obs.</strong></td>
<td>1711</td>
<td>1676</td>
</tr>
<tr>
<td></td>
<td>1711</td>
<td>1676</td>
</tr>
<tr>
<td><strong>$R^2$</strong></td>
<td>0.437</td>
<td>0.386</td>
</tr>
<tr>
<td></td>
<td>0.355</td>
<td>0.385</td>
</tr>
</tbody>
</table>

Note: *** $p<0.01$, ** $p<0.05$, * $p<0.1$  Robust errors in parentheses

Economic crisis, recoveries and booms lose their significance for Budget Deficit explanation (compare with Barro, 1979; Barro, 1986) as soon as we include Taxpayers Democracy epoch data in the sample. Our explanation (speculative at the moment) of the Japanese special case is that Japan was able to extort rent from the occupied territories during the war.37

Tables 4 and 5 shows regressions for the second hypothesis. They show that explanatory power of the ‘left-wing voting’ variables is approximately the same as ‘universal suffrage’, ‘civil law’ and religion taken together. The sign implies that leftist parties contribute both to the growth of budget deficit (Table 4) and inflation (Table 5).

---

37 Europeans routinely fail to follow “the basic principle” formulated by Napoleon Bonaparte: “Armies must feed themselves at the expense of the enemy’s territory.” (Keyes R., 2006)
TABLE 4. LEFT PARTIES INCREASE DEFICIT MORE THAN DEPRESSION38

<table>
<thead>
<tr>
<th></th>
<th>Dependent variable: Central Gov-t Balance (inverse Deficit)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OLS</td>
</tr>
<tr>
<td></td>
<td>OLS</td>
</tr>
<tr>
<td></td>
<td>FE</td>
</tr>
<tr>
<td></td>
<td>FE</td>
</tr>
<tr>
<td><strong>GDP per cap. growth</strong></td>
<td><strong>OLS</strong></td>
</tr>
<tr>
<td></td>
<td><strong>OLS</strong></td>
</tr>
<tr>
<td></td>
<td><strong>FE</strong></td>
</tr>
<tr>
<td></td>
<td><strong>FE</strong></td>
</tr>
<tr>
<td>GDP per cap. growth</td>
<td>(1)</td>
</tr>
<tr>
<td></td>
<td>(2)</td>
</tr>
<tr>
<td></td>
<td>(3)</td>
</tr>
<tr>
<td></td>
<td>(4)</td>
</tr>
<tr>
<td><strong>Dependent variable:</strong></td>
<td><strong>Central Gov-t Balance</strong> (inverse Deficit)</td>
</tr>
<tr>
<td></td>
<td><strong>OLS</strong></td>
</tr>
<tr>
<td></td>
<td><strong>OLS</strong></td>
</tr>
<tr>
<td></td>
<td><strong>FE</strong></td>
</tr>
<tr>
<td></td>
<td><strong>FE</strong></td>
</tr>
<tr>
<td>GDP per cap. growth</td>
<td>−0.037 (0.057)</td>
</tr>
<tr>
<td></td>
<td>0.043*** (0.005)</td>
</tr>
<tr>
<td></td>
<td>0.044*** (0.006)</td>
</tr>
<tr>
<td></td>
<td>0.028*** (0.008)</td>
</tr>
<tr>
<td></td>
<td>0.029*** (0.010)</td>
</tr>
<tr>
<td>Great Wars</td>
<td>16.20*** (2.15)</td>
</tr>
<tr>
<td></td>
<td>16.23*** (2.153)</td>
</tr>
<tr>
<td>Great Wars</td>
<td>16.397*** (3.502)</td>
</tr>
<tr>
<td></td>
<td>16.436*** (3.481)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>0.893*** (0.293)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>1.022*** (0.303)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>0.989* (0.54)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>1.127* (0.625)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.467** (0.194)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.494** (0.193)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.641*** (0.076)</td>
</tr>
<tr>
<td>GDP</td>
<td>0.693*** (0.093)</td>
</tr>
<tr>
<td>Japan dummy</td>
<td>−5.524*** (0.731)</td>
</tr>
<tr>
<td>Japan dummy</td>
<td>−5.824*** (0.735)</td>
</tr>
<tr>
<td>Japan dummy</td>
<td>−5.364 (0.261)</td>
</tr>
<tr>
<td>USA dummy</td>
<td>−0.336 (0.265)</td>
</tr>
<tr>
<td>USA dummy</td>
<td>−0.43*** (0.137)</td>
</tr>
<tr>
<td>USA dummy</td>
<td>0.441*** (0.164)</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.382</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.392</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.330</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.338</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1  Robust errors in parentheses

As modern GDP significantly outweighs earliest values of the same indicator it positively correlates with highest (modern) values of the budget deficit.

38 The same regressions on the Dataset containing imputed values see in Supplementary materials Table A5
Organized in Table 5. Left Parties' Power Increases Inflation and Regulatory Burden.

<table>
<thead>
<tr>
<th></th>
<th>Depended variables: Inflation (CPI)</th>
<th>Freedom from regulations (HIEL)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OLS</td>
<td>FE</td>
</tr>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>Leftists</td>
<td>0.130*** (0.015)</td>
<td>0.142*** (0.032)</td>
</tr>
<tr>
<td>GDP</td>
<td>−0.259 (0.256)</td>
<td>−0.266 (0.163)</td>
</tr>
<tr>
<td>Great Wars</td>
<td>14.662*** (2.525)</td>
<td>14.613*** (3.781)</td>
</tr>
<tr>
<td>Local Wars</td>
<td>3.112** (1.132)</td>
<td>2.668 (1.749)</td>
</tr>
<tr>
<td>Civil Law</td>
<td></td>
<td>−0.27*** (0.006)</td>
</tr>
<tr>
<td>Protestant</td>
<td></td>
<td>0.51*** (0.06)</td>
</tr>
<tr>
<td>Gov_Railways</td>
<td></td>
<td>−0.17** (0.06)</td>
</tr>
<tr>
<td>Const</td>
<td>0.367 (0.366)</td>
<td>8.79*** (0.07)</td>
</tr>
<tr>
<td>Number of obs.</td>
<td>1659</td>
<td>1659</td>
</tr>
<tr>
<td>Adjusted (overall) $R^2$</td>
<td>0.044</td>
<td>0.044</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1  Robust errors in parentheses

Mixed public goods provide much more opportunities to increase expenditures, than pure public goods (democratic countries military expenses usually do not exceed 3-5% of GDP or 5-7% including wartime debt repayment – see Eloranta, 2007; Yanovskiy, Zatcovetsky, 2017). So the regression outcomes help to explain the governmental spending expansion political mechanism as well as poorly-controlled peacetime budget deficits. Since universal suffrage generated favorable conditions for left parties’ rise to power, the left pushes more and more redistribution and social services expenses.

Sorrentino (1983) pointed out the trend of a decrease in males’ participation in labor force, simultaneously with the female’s participation increase. The simplest interpretation is that “cradle to grave” government causes the gradual deterioration of the male labor ethic. Deteriorating family responsibility and declining breadwinner’s duty discourages men to work. Female employment reflects the growing uncertainty of women within the family and
a generally weakened family institution. The connection of the declining family institution and the universal suffrage was studied by Shestakov et al (2013).

**TABLE 6. LEFT PARTIESLASTING SUPPORT NEGATIVELY CORRELATES WITH MALE LABOR FORCE PARTICIPATION**

<table>
<thead>
<tr>
<th>Depended Variable: Male Labor Force Participation</th>
<th>OLS (1)</th>
<th>OLS (2)</th>
<th>FE (3)</th>
<th>FE (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Leftists</strong></td>
<td>-0.183*** (0.029)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Leftists (~20)</strong></td>
<td></td>
<td>-0.287*** (0.026)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Leftists (~30)</strong></td>
<td></td>
<td></td>
<td>-0.269*** (0.026)</td>
<td></td>
</tr>
<tr>
<td><strong>Leftists (~40)</strong></td>
<td></td>
<td></td>
<td></td>
<td>-0.274*** (0.022)</td>
</tr>
<tr>
<td><strong>GDP per cap. growth</strong></td>
<td>0.295*** (0.112)</td>
<td>0.116 (0.076)</td>
<td>-0.074 (0.065)</td>
<td>0.088 (0.062)</td>
</tr>
<tr>
<td><strong>Local Wars</strong></td>
<td>0.062 (1.084)</td>
<td>-0.573 (1.137)</td>
<td>0.784 (1.027)</td>
<td>0.850 (0.883)</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>2.505*** (0.925)</td>
<td>4.341*** (0.536)</td>
<td>3.322*** (0.524)</td>
<td>0.600 (0.503)</td>
</tr>
<tr>
<td><strong>USA</strong></td>
<td>-3.388** (1.405)</td>
<td>-6.354*** (1.192)</td>
<td>-5.949*** (1.174)</td>
<td>-5.958*** (1.033)</td>
</tr>
<tr>
<td><strong>Const</strong></td>
<td>80.845*** (1.203)</td>
<td>84.413*** (0.978)</td>
<td>83.545*** (0.978)</td>
<td>83.5965*** (0.841)</td>
</tr>
<tr>
<td><strong>Number of obs.</strong></td>
<td>476</td>
<td>462</td>
<td>435</td>
<td>421</td>
</tr>
<tr>
<td><strong>Adjusted R²</strong></td>
<td>0.123</td>
<td>0.283</td>
<td>0.270</td>
<td>0.318</td>
</tr>
</tbody>
</table>

Note: *** p<0.01, ** p<0.05, * p<0.1  Robust errors in parentheses

The data collected for our statistical analysis support grave concern about voters’ morale and responsibility trend under the universal suffrage.

---

39 The same regressions on the Dataset containing imputed values see in Supplementary materials Table A7

40 “The traditional American virtues – of liberty, hard work, free enterprise, private initiative and aspirations to moral greatness – no longer inspire or animate a majority of the electorate... it is impossible to compete against free stuff” (Pruzansky, 2012).
5. DISCUSSION: INTENDED CONSEQUENCES: REPRODUCTION OF HEAVY TAX BURDEN AND EXCESSIVE REGULATIONS

The introduction of new entitlement programs is in an elected politician’s self interest under universal suffrage. A well-designed program significantly benefits targeted voters while remaining quite affordable for the rest of the voters (the machinery is very similar to special interest groups, Olson, 1982). The incentive to “buy” voters by entitlements or by the expansion of the public sector to ensure re-election is extraordinary.

Tax burdens under progressive rates are far from equal, so 5-10% of voters usually pay the lion’s share of taxes\(^{41}\). The political power of such taxpayers and their ability to fight back are restricted, but significant. Thus a politician’s attempt to pay for new spending with additional taxes or a higher taxation rate could be rejected by voters and damage his political career (or aspirations).

The toughest challenge is to cut spending and cancel entitlement programs.

Mass civil unrest is routinely created by any attempts to cut spending. The protests and opposition to new or higher taxes are not unique. But it is difficult to find examples of the public or elected officials objecting to new and costly entitlement programs despite the possibility of a financial crises and heavier taxation in long run.

The various governmental departments compete for their “fair share” of budget allocations, a difficult if not impossible balancing exercise when every department, special interest group and political faction demands additional funding. Political leaders can seldom reconcile the competing demands, preferring to “kick the can down the road” and defer the problem to a future government or generation, leading to a chronic budget deficit and rapidly increasing national debt.

Balancing the budget is further confounded by the “logrolling,” i.e., agreements among factions to reciprocally support legislation and attendant funding.

So, the balance of political power under universal suffrage is poorly designed to balance the budget in the long run. Universal suffrage creates a highly politicized budget process unlikely to result in a balanced budget.

Competition for budget shares among departments is regularly accompanied by the creation or invention of new governmental programs, which must be financed, new responsibilities and respective powers (the more discretionary, the better). The government’s regular failure to balance the budget indicates the success of special interest groups.

The paupers’ franchise naturally leads to the presumption of the “bounded capacity” of the consumer and worker who need to be protected by business regulations.

The natural alliance of civil bureaucrats and paupers stokes anti-capitalist ideology or sentiments. The prevalent ideology creates the legal presumption that businesses are acting in bad faith (mala fide). Naturally, the representatives of welfare-dependent voters – their

elected politicians — claim that there is an urgent need for more business regulations. The expansion of various business regulations and, more broadly, the belief and willingness to cure every social vice by extensive legislation indicate the acuteness of the problem. (Green, 1993, p.17; Leoni, 1961). Jasay’s model of power-maximizing State (Jasay, 1985) predicts the same development of the regulations (freedom of contract erosion, p. 22).

Is a Return to the Democracy of the Taxpayer a Feasible Option?

If returning to the democracy of the taxpayer is a priori unrealistic, does it make any sense to focus on the flaws inherent in universal suffrage? It seems that the overwhelming majority of economists ignore the problems associated with this institution precisely because of their implicit belief that no feasible alternative to universal suffrage exists42. Yet the experience of post-communist transition shows that depriving a significant part of the adult population of voting rights (privileges) is quite realizable.43 Moreover, it can be done even under the pressure of economic hardship and unfavorable foreign political circumstances. E.g., in Estonia and Latvia in 1991, one-quarter to one-third of the adult population lost their voting rights as a result of due parliamentary procedure by law. The formal grounding for this was that those people were not descended from citizens of the independent republics (1918-1939) but had settled in the Baltic countries illegally as Soviet colonists.

Such criterion is much worse (in the economic sense) than the criteria of taxpaying or property-owning. Inside the “citizen descendants” group the principles of universal suffrage remained unchanged.

A large number of those who had lost the right to vote (retired USSR military and the like) were soon granted Russian citizenship. In 1996, they took part en masse in the Russian presidential elections. G. Zyuganov, the communist candidate, got 66.7% of the votes cast by the 65,182 Russian voters in Latvia and 62.3% of the 74,046 votes in Estonia. Another 14% in Estonia and more than 10% in Latvia voted for the (Russian) nationalist candidate A. Lebed. This considerable number of votes would have been sufficient to form strong anti-market parties in both countries. In reality, in the absence of these voters, the elections in Latvia and Estonia saw right-centrist and rightist parties competing each other. The level of demand for free market ideas and, given crisis conditions, for strict economy policies turned out to be unusually high for countries of the Central and Eastern Europe,

42 A distinguished critic reacts to the paper (overlooking this paragraph): “… other than armed rebellion, it is impractical to think that a democratic polity ever would support any narrowing of the franchise. In fact, we now see proposals to allow convicted felons to vote!”

43 Cases of the restriction of the given franchise are recorded several times (Congleton, 2011 p. 550). For example, in several southern states of the US, following the 1877 Compromise electoral qualifications were introduced to restrict voting by African Americans. In more recent times French Legislative Assembly by its edict of 31 May 1850 introduced residential and taxpayer qualifications. Qualifications prohibited the vote to approximately one third of the male population (Berenson, Duclert, Prochasson, 2011 p. 32). Formal abandonment of the qualification by Louis-Napoleon was impaired by the coup and the end of the Second Republic and democracy.
to say nothing about the post-Soviet states. It also should be noted that introducing a universal qualifying requirement at the time of naturalization posed no obstacle to substantial increase in the number of voters in these countries during the years 1991-2013.

This historical experiment suggests that the number of voters will decline when the tax-paying qualification is introduced, but in long run (within 1-2 generations) more people will meet the requirements to vote, so the share of enfranchised adults will eventually reach (converge to) the level of approximately 70-90 percent of the adult population. In addition, the new voters’ incentives will be qualitatively higher because they will have no conflict of interest.

6. CONCLUSIONS

The introduction of universal suffrage created, first and foremost, ethical problems (conflict of interest) and ultimately, unwanted social and economic consequences. Universal suffrage creates – and perpetuates wrong incentives for budget-dependent voters, for their elected leaders and for civil bureaucrats. Universal Suffrage creates institutions that infantilize the electorate, destabilize public finances and contribute to an increased regulatory burden.

Electoral support of political left rose as a result of the universal suffrage. The left parties’ strength contributed to peacetime government finance destabilization (budget deficit, etc) and regulatory burden increase. The dependencies have been demonstrated by incentives quality analysis and also verified quantitatively.

It looks like the forecast made by John Adams and John C. Calhoun came true: universal suffrage caused incentives to redistribute (though with a significant lag, as actually predicted by Adams). Therefore, the suffrage of voters facing permanent conflict of interest should be revoked.

Old democracies from our past proved the feasibility of balanced state budget. So taxpayers’ democracy could alleviate the conflict of interest for a long time though not forever. Probably, newly democratic nations just cannot afford universal suffrage.

History, including the post-socialist transition of Estonia and Latvia, prove that there are political opportunities to escape from the universal suffrage trap.

44 See Supplemental materials for data and references. No significant civil disobedience of disenfranchised people took place, even despite numerous attempts of Russian officials and their affiliate structures to incite and to organize them – see Supplemental materials for references.

45 Even under the property qualification up to 50-75% of adult white men were enfranchised to vote on the eve of US Revolution (Schweikart, Allen, 2014, Kindle location 2578–2580).

46 See section 6 – table 7 of Supplemental materials for some patterns of qualification to vote and disqualification criterions.
REFERENCES


Schweikart, Larry and Allen, Michael Patrick (2014) *A Patriot's History of the United States: From Columbus's Great Discovery to the War on Terror*. Penguin Group US.


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