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# DEMOCRACY, CAPITALISM, AND EQUALITY: THE IMPORTANCE OF IMPERSONAL RULES

Naomi R. Lamoreaux
John Joseph Wallis

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## ABSTRACT

We usually consider it progress when a country begins to shift from an autocratic to a democratic form of government. However, the introduction of elections and other early trappings of democracy often has the perverse effect of exacerbating political instability. It also increases the incentives for those in power to manipulate the economy for political ends and thus often negatively affects economic growth. We argue that the key to getting beyond these pernicious effects—to reconciling democracy and capitalism—is to move to a governance structure based on impersonal rules that apply in the same way to everyone (or at least to broad categories of everyone). We lay out the theoretical basis for this argument and illustrate it with evidence about how the transformation worked (or not) in the case of the United States, United Kingdom, and Germany.

Naomi R. Lamoreaux
Yale University
111 N Ashley St
Ste 307
Ann Arbor, MI 48104
and NBER
naomi.lamoreaux@yale.edu

John Joseph Wallis
Department of Economics
University of Maryland
College Park, MD 20742
and NBER
wallis@econ.umd.edu

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## 1. Introduction

There are ways of thinking about democracy and capitalism that make them seem irreconcilable. If capitalism is an economic system that allows a considerable degree of economic freedom and enables a small number of hard working or lucky individuals to accumulate substantial wealth, then capitalism may have an inherent tendency to increase inequality. If democracies gain legitimacy by leveling the playing field for their citizens, both politically and economically, then the unequal accumulation of wealth generated by a capitalist economic system may eventually erode the foundations of democracy. Viewed from this perspective, capitalism and democracy seem incompatible.[1]

To most economic historians, however, the answer to the question "Can democracy and capitalism be reconciled?" is an obvious "Yes." A glance around the world suggests that all of today's "advanced" capitalist societies are both rich and advanced democracies, and all of today's "advanced" democracies are rich and advanced capitalist societies. Indeed, democracy and capitalism developed together so closely over the last two centuries that asking whether democratic development caused modern economic development or modern economic development caused democratic development has long been a foundational question in economics, economic history, and political science. Few economic historians doubt that democracy and capitalism emerged in tandem. The debates are all about how and why.

[1] The idea that democracy and capitalism cannot coexist has a long history, as Göran Therborn (1977, p. 3) has pointed out.

The modifier "advanced" in the preceding paragraph is crucial. As we show in this chapter, only societies with *advanced democratic polities* are associated with *advanced capitalist economies*. If we define a democracy simply as a society that selects leaders through some form of election, or if we define a capitalist society simply as one where economic actors pursue profits, then the relationship between democracy and economic development disappears. In other words, there is a strong association between advanced democracy and advanced capitalism, but little or no relationship between democracy and capitalism broadly defined. Why this is so is the subject of this essay. In brief, we argue that today's advanced capitalist democracies began to undergo changes in the late-nineteenth and early-twentieth centuries that transformed both their economic and political systems in mutually reinforcing ways. The changes in the organization of political institutions that occurred during this period would not have been sustainable without the corresponding changes that occurred in the organization of economic institutions, and vice versa. At the root of this double transformation was the adoption of impersonal legal rules—that is, rules that treated everyone (or, more accurately, broad categories of everyone) the same. Impersonal rules facilitated the free flow of resources to their most profitable economic uses that is the hallmark of advanced capitalism. They also made possible the emergence of the stable long-lived political parties that are the essential features of advanced democracies. Although they did not eliminate inequality or, for that matter, discrimination, they created peaceful, prosperous societies whose citizens benefited from a broad set of civil liberties.

Aside from the small number of advanced capitalist democracies, most societies around the world today have (and always have had) unstable political systems. Political elites in these societies try to stave off conflict by agreeing to allocate each other what economists call "rents." The rents are created by "identity" rules—that is, rules that treat different members of the elite

differently and whose form and enforcement depend upon the social identity of the individuals to whom they apply. Because the rents will be lost if these agreements collapse, the identity rules that enable them also create incentives not to violate them. The incentives are imperfect, however. Members of the elite are always jockeying for better deals, and the value of the rents can never be fixed through time. Indeed, rents can dissipate for completely idiosyncratic reasons. As a result, this kind of political manipulation of economic interests can be at best a source of short-run stability. At some point, the agreements will collapse.[2]

Although most writers consider it progress when countries begin to choose leaders by election, the move toward democracy can exacerbate problems of instability in a society governed by identity rules. Elections introduce considerable randomness to the choice of leaders, making it more difficult for elites to come to agreements in the first place and making the agreements they manage to reach less secure. The resulting uncertainty in turn increases the incentive for elites to solidify their coalitions by manufacturing new privileges they can distribute to their allies. Thus, the spread of electoral democracy can have the perverse effect of worsening both political instability and the extent of economic distortions.

Although opposition parties often promise to put a stop to this kind of corruption when they come to power, they rarely follow through because they too need to reward supporters to win elections. During the second half of the nineteenth century, however, a small group of countries found ways to limit significantly this kind of manipulation by mandating that the rules that governed their societies be impersonal. These countries became the advanced capitalist democracies of today. Each of them made the transition in its own way. There was no common route to change—no recipe that other countries could follow and become advanced. But in each

[2] The logic of this argument is laid out in North, Wallis, and Weingast (2009).

of the countries that figured out how to do it, the adoption of impersonal rules set in motion a similar set of processes that transformed the way the economic and political systems worked and interacted. Most obviously, the resulting limits on rent creation encouraged capitalist economic development by reducing the barriers that had inhibited the free movement of economic resources. Less obviously, the same developments strengthened the organizations—political parties—that mediated between the government and the electorate, directing political competition into channels that were no longer destabilizing.

In the next section of the chapter, we define what we mean by advanced capitalism and advanced democracy and document the association between these two systems using estimates of real per capita income and a widely used measure of democracy, the Polity V Score. The third section then explains why the association between democracy and capitalism does not hold below the set of advanced capitalist democracies. It begins by describing how societies governed by identity rules work, why they are plagued by instability, and why they constrain capitalist economic development. Next it explains how introducing democracy into such societies makes them more unstable and, often, poorer. The fourth section shows how mandating impersonal rules transforms these societies—how it removes the barriers that prevented resources from flowing to their best uses, allowing capitalism to thrive, and how it transforms the way the democratic political process works by giving rise to stable party systems. Finally, in section five, we review the little that is known about how today's advanced capitalist democracies adopted impersonal rules, highlighting the difficult, context-specific character of these transitions by focusing on the cases of the United States, the United Kingdom, and Germany. Section six concludes.

## 2. Definitions and Measurement

To show that there is an association between advanced capitalist societies and advanced democracies, but not between capitalism and democracy more generally, requires that we be as clear as possible about our terms. Even so, measuring the extent to which countries fit our definitions is difficult because the available metrics are imperfect proxies for the characteristics we seek to capture. We are primarily interested, however, in the difference between advanced democratic capitalisms and all other societies, rather than with finely graded distinctions across the full spectrum of countries, so the measures are good enough for our purposes.

For all the discussion of capitalism in the literature, scholars have devoted relatively little effort to defining and measuring it. Marx, of course, conceived of capitalism as an economic system in which labor was the sole source of value in the economy but workers did not own the means of production and had to sell their labor to the capitalists who did to survive.[3] Once the labor theory of value gave way to the idea that profits depend on the efficient combination of multiple factors of production, however, it became common for scholars to define capitalism very simply as a system where economic actors were motivated primarily by the pursuit of profits.[4] There are two problems with this definition. First, it does not allow us to distinguish societies that most people consider capitalist from others that most do not (like feudalism), where elites may also be motivated by the desire for economic gain. Second, it does not allow us to distinguish societies in which profit-oriented elites are able to cut rent-creating deals that limit

[3] Marx (1887), Vol. I.

[4] See, for example, Joyce Appleby's definition (2010, p. 7). Although historians of capitalism have generally been reluctant to define their terms, when pushed they fall back on a similar definition. See Beckert, et al. (2014). Jonathan Levy (2021, pp. xiii-xx) defines capitalism essentially as the securitization of assets. His definition is creative but not very useful for our purposes.

the free flow of resources into profitable economic activities.[5] To avoid these problems, we prefer to categorize societies as more or less capitalist depending on the prevalence of such rent-creating arrangements. Advanced capitalist economies are those in which these kinds of barriers to entry have been largely removed, and entrepreneurs are free to invest their capital, workers are free to invest their labor, and resource owners are free to invest their property in almost any kind of venture they choose. In advanced capitalist societies, any person can form an organization, access government-enforced rules to structure it, and engage in a wide variety of activities without the explicit approval of the government. The forms of supported organizations are rich and varied, the scale of organizations can range from very small to very large, and new organizations, purposes, and products appear and disappear frequently.

There is a good deal of overlap between our definition of capitalism as an economic system in which individuals can use their capital, labor, land, and resources however they think best and the measures of economic freedom in Vincent Geloso and Alex Tabarrok's paper in this volume. However, in our view, even though advanced capitalist societies are characterized by the free movement of economic resources, they are not necessarily laissez-faire. As the "varieties of capitalism" literature has shown, such societies can differ considerably in the extent to which they regulate economic activity in the interests of health, safety, environmental sustainability, and other social goods, and in the extent to which they provide a social safety net.[6] Within the general constraints imposed by these types of regulatory policies, what matters is that capital, labor, and resources flow freely wherever their owners direct them. The key to *advanced*

[5] On the importance of making this distinction, see Baumol (1990).
[6] The foundational work in this literature is Hall and Soskice (2001).

*capitalism* is not the absence of limits on economic activity, it is that *everyone* faces the *same* limits and enjoys the *same* freedoms.[7]

Although one can articulate the difference between advanced capitalist societies and their more basic capitalist counterparts, there are no comprehensive indices that capture these distinctions over space and time. We have chosen for our analysis what we think is the most reasonable metric available: real per capita income. The idea here is that, all other things being equal, societies with fewer barriers to the free flow of economic resources will be richer than those where profitable opportunities are limited to government favorites. We use the data on per capita income that Angus Maddison has compiled for a wide selection of countries over the last two centuries. Some of Maddison's estimates are little better than guesses, and coverage is spottier at the beginning of the period than at the end, but the data convey a general picture of trends in real income over time and across countries, which is all we need for our purposes.[8]

Scholars have devoted a great deal more effort to defining and measuring democracy than they have to capitalism. At the simplest level, democracy is a political system that selects leaders through elections. Joseph Schumpeter defined democracy this way in *Capitalism, Socialism, and Democracy*, contrasting it with the classical notion of democracy as a pure "ideal" type of political system in which elections somehow express the will of the people.[9] But democracy involves much more than elections. David Collier and Stephen Levitsky have specified a "procedural minimum" for being a democracy that presumes "fully contested

[7] In many developing countries with weak state capacity there may be few formal regulations on economic activity, nonetheless the ability of individuals to use their resources may be severely limited by political arrangements.

[8] We are using the 2010 version of Maddison's data, because there are benchmarking problems with the revised series.

[9] Schumpeter (1942, Chs. 21 and 22). For a brilliant discussion of how democracy as an ideal type differs from actual democracies, see Dahl (1971).

elections with full suffrage and the absence of massive fraud, combined with effective guarantees of civil liberties, including freedom of speech, assembly, and association." Many countries that hold elections to select leaders are unable to meet even this basic standard. An "*expanded* procedural minimum" for democracy requires in addition that elected governments have effective power to govern. The expanded definition excludes political systems where elections are free, fair, and open, but the elected government does not fully control the state, as, for example, in countries where the military exercises independent power. In democracies that meet this expanded definition, the parties or coalitions that win elections are the organizations that control the government, which means that the policies governments put into effect and the rules they promulgate depend on the outcome of elections.[10]

What we call advanced democracies exhibit all the characteristics of electoral democracies that meet the expanded minimum standard. In addition, they have the enhanced stability that comes from the development of a relatively small number of major consolidated parties with durable lives.[11] These major parties neither suppress their opponents when they win elections nor disappear from the political scene when they lose them. Although one of the parties might prevail for a considerable period, in general they all have reasonable chances of winning elections, or of participating in a governing coalition, and therefore of determining the policies pursued by the state. Although advanced democracies all have consolidated party systems, other details of their political structures—the number of parties, whether they are

[10] Collier and Levitsky (1997). For a similar typology, see Schedler (1998).
[11] In a consolidated party system there are a small number of major parties with a reasonable chance of winning elections or participating in governing coalitions. The rules for forming parties, however, are open to anyone meeting minimal criteria. As a result, there may be many parties on the ballot, but few with any real chance of winning the election. See Schattschneider (1942).

parliamentary or characterized by separation of powers, whether representation is majoritarian or proportional, and so on—can vary significantly from one country to the next. Indeed, there is a varieties of democracy literature that parallels, and feeds into, that on capitalism.[12]

Political scientists have constructed various indices that measure democracy numerically. The one we use here is the Polity Score V, which ranks countries on a 21-point scale ranging from -10 to +10. Negative numbers indicate how autocratic a society's political system is, positive numbers how democratic. The Polity Score is built up from component indices that measure different aspects of a country's governance. It gives considerable weight to how the executive is chosen and to constraints on the power of the executive, as well as to the extent of political competition, and therefore highlights the characteristic features of democracies that meet the expanded minimum standard. Because its components are less able to detect the presence of consolidated political parties, some of the countries that receive Polity Scores of +10 may not be advanced democracies by our definition. Nonetheless, the index is well designed to capture gradations of autocracy and democracy and, usefully for our purposes of correlating capitalism and democracy, is not confounded by the inclusion of variables that measure economic policy.[13]

For the purposes of this paper, we divide the political world conceptually into autocracies, electoral democracies, and advanced democracies. Our concern is with the line between advanced democracies and all other systems. Although we recognize that there is significant variation among countries on both sides of this line, we seek to understand how

[12] For an example, see Lijphart (2012).
[13] Another prominent measure of democracy, V-Dem, includes such confounding variables, as well as many that work against our ability to pick up the presence of consolidated political parties.

advanced democracies differ from all other democracies and to explain why it is advanced democracy in particular that is consistent with advanced capitalism.

<Table 1 about here>

Table 1 reports correlations between per capita income and Polity V Scores for countries for which both measures are available in 2000, broken down into various sub-samples. Because the Middle Eastern oil producers are rich despite being autocratic, we drop them from the analysis, but we report correlations that include them in the notes. At the top of the world income distribution—the 25 richest countries, not including these oil producers—the correlation between our measures of capitalism and democracy is weakly positive and marginally significant; most of the countries in this group have Polity Scores of 10, so there is little variation on the democracy side. However, as we expand the sample from the top 25 non-oil countries to the top 66 non-oil countries, and then to all the non-oil countries, the correlation coefficient rises from 0.22 to 0.47 to 0.55, and the statistical significance of the correlation increases. So long as the richest countries are in the sample, adding more poor countries increases the measured correlation, but the pattern is driven entirely by the richest set of countries. If we look only at the poorest 66 countries in the dataset, the correlation virtually disappears and becomes insignificant. The correlation coefficient is 0.08 with a p value of 0.25.

<Figure 1 about here>

This lack of an association between our measures of capitalism and democracy for countries in the bottom half of the distribution can be seen graphically in Figure 1, which plots the income of the richest country in a given sample on the horizontal axis and the correlation between per capita income and the Polity Score for that same sample on the vertical axis (the income numbers on the horizontal axis are negative to make the graph read from left to right).

The first observation is the full sample of countries (excluding the Middle Eastern oil producers), ranging from Norway with a per capita income of $54,040 in 2000 to Afghanistan with an income of just $502. The second observation drops Norway and measures the correlation from the United States at $45,886 to Afghanistan. The last observation is the correlation for the poorest 27 countries (Bangladesh at $1,845 to Afghanistan). As the rich countries disappear from the sample, the correlation between per capita income and Polity Scores declines, becoming statistically insignificant around a correlation of 0.2 and a top income in the range $10,000 to $12,000 (roughly the income of the Russian Federation). For the bottom three quarters of the countries there is little correlation between Polity Scores and per capita income, and at the very lowest levels of the distribution the correlation actually becomes negative, suggesting that poor countries with autocratic governments may have higher incomes that those that are democracies. Those results are not statistically significant, however.

The association between advanced capitalism and advanced democracy that we have documented is just that—a correlation. We have not proven anything about the effect of democracy on capitalism or of capitalism on democracy. Nor have we ruled out the possibility that other phenomena are behind the correlation we observe. In the next two sections, we tackle the task of explanation.

### 3. Why Identity Rules Cannot Support Advanced Capitalist Democracies

As we suggested above, a distinguishing feature of advanced capitalist democracies is that they are governed by impersonal rules rather than identity rules. Indeed, we would go farther and assert that impersonal rules are a critical requirement for the positive association we observe between advanced democracy and advanced capitalism. In this section, we develop the

logic of this claim. We first explain that autocracies and oligarchic republics always operate under identity rules because that is how ruling coalitions create the rents that give elites an interest in preserving social order. These coalitions are subject to collapse, however, because the deals that structure them are inherently unstable. They are also bad for capitalist development because rent-creation depends on the erection of barriers to the free flow of economic resources. We then show that the introduction of democracy typically makes both problems worse because the greater uncertainty of electoral outcomes increases political instability and hence the imperative to deploy rent-creating identity rules. In the next section, we round out the argument by showing how everything changes with the shift to impersonal rules.

The importance of identity rules is most obvious in autocracies and oligarchies. These societies are prone to coups, uprisings, and civil wars as different factions of the elite jockey for power. Agreements among powerful factions are vital to establishing and maintaining order, but they can only last if the elites involved in them have a stake in their continuance—if they earn valuable rents that will be lost if the arrangements fall apart. Thus, identity rules that create rents—that assign lucrative government offices or valuable monopoly privileges to strategically important political actors—are essential for preventing violent breakdowns.[14]

Coalitions organized by identity rules necessarily include groups with competing, even antagonistic interests. They are not just made up of allies. Maintaining social order depends on inducing the powerful factions that are most likely to fight each other to agree to cooperate. To give a recent example, former president Mwai Kibaki of Kenya was declared the winner of the 2007 elections despite the claims of his opponent, Raila Odinga, that the election had been

[14] For the underlying logic, see North, Wallis, and Weingast (2009). For a similar understanding, see Haber, Maurer, and Razo (2003).

manipulated. Violent protests broke out and Kenya seemed on the verge of civil war, but violence was forestalled by an agreement between the Kibaki and Odinga organizations that allowed the former to assume the presidency. Entitled the National Accord and Reconciliation Act of 2008, the agreement rewrote the constitution and created the office of Prime Minister, which was given to Odinga. The Accord was an intra-elite agreement between enemies, not allies, and very consciously used identity rules to quell violence.[15]

Societies organized by identity rules are inherently "factional" in the sense that they are dominated by small groups of elites with distinct and different interests who join together to form coalitions to govern and to influence what the government does. These coalitions, and the factions that make them up, are fluid and constantly changing. As a result, inter-elite agreements can only maintain the peace for limited periods of time. Over the long run, changes in the relative power of the factions involved, or the emergence of a powerful faction from outside the agreement, can lead to outbreaks of violence. The rise of the Odinga organization in Kenya is a good example. Moreover, the rents that hold a coalition together can shift or even dissipate for exogenous reasons, forcing the agreement to be renegotiated and threatening violence. In eighteenth-century Britain, for example, a glut in the world market for tea led the crown to bolster the monopoly of the East India Company, whose investors formed a crucial part of the ruling coalition, at the cost of provoking a rebellion in British North America.[16]

Some ruling coalitions are autocracies, where one set of elites controls the government; some are oligarchies, where control is shared by a broader combination of elites. Although autocracies may appear to be more stable than oligarchies, they too are riven by factions.

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[15] Gettleman (2007). See also Cheeseman's introduction to the 2008 issue of the *Journal of Eastern African Studies*, which is devoted to the Kenyan election.
[16] Schlesinger (1918).

Autocrats always govern in the shadow of violence and must use rents to induce other powerful elites to refrain from using force against them. Nonetheless, in autocracies the person of the monarch or dictator provides a focal point that facilitates the coordination of agreements. In oligarchies, the coordination problem is more difficult. Agreements are both harder to reach and more prone to collapse.

Elites in oligarchies always fear that one faction among them will gain control of the government and will use that control to dominate or eliminate the other factions. In early modern Europe, this fear drove the development of the republican ideas and institutions that to this day claim the admiration of political theorists. To protect what they termed their "rights and liberties" from the tyranny that would result from such domination, republican thinkers advocated mixed and balanced government. They did not understand that what they called their rights and liberties were the product of identity rules; nor did they see factions as the characteristic outcome of societies structured by identity rules. To the contrary, they conceived of factions as natural phenomena—as products of human nature—and they could not imagine that societies could be organized without them. The mixed and balanced governments that republican thinkers promoted did nothing to eliminate factions; that, they thought, was impossible. Instead, the goal of these thinkers was to prevent tyranny by structuring the government so that factions counter balanced one another and none was able to dominate.[17]

The republican thinkers who promoted mixed and balance government did not advocate democracy, but their ideas nonetheless provided a critical foundation for the democratic reforms of the late eighteenth and early nineteenth centuries. Although these reforms are usually

[17] The literature on republican ideas is enormous. Two seminal books are Pocock (1975) and Bailyn (1967).

considered milestones of human progress, their introduction into societies structured by identity rules had the perverse effect of making problems of instability worse, as the violent conflicts of the age of revolutions suggest. Figure 2 shows that this effect is still evident in democratizing countries today. The figure graphs the relationship between Polity V Scores and political instability, measured in several ways. The vertical axis reports the likelihood that an unstable event will occur in a given year, and the horizontal axis the country's Polity V Score. As the figure shows, countries with very high Polity Scores (advanced democracies) are the most stable in the world. Countries with very low Polity Scores are also relatively stable. But as autocracies incorporate more democratic elements (mainly elections) into their political processes and move toward electoral democracies, they become less stable. Their chance of armed conflict and of backsliding into autocracy increases—that is, unless, against the odds, they manage to continue to democratize.[18]

<Figure 2 about here>

Democratization makes achieving political stability more difficult for several reasons. In the first place, elections add an element of uncertainty to the selection of governments and, as a result, make agreements among elites more difficult to reach. More importantly, when the outcome of elections is determined by a majority vote (or another voting rule), groups have incentives to form coalitions of just enough factions to secure victory and to leave others (usually enemies) out of the rule-making process and the privileges that result from it. However, leaving antagonistic factions out of the agreement may doom it. The recent literature on civil wars shows that factionalized polities are more likely to be disrupted by violence when a group comes to feel

[18] Scholars have found that most civil wars occur in countries with Polity Scores between -5 and +5 and call these places "anocracies" to emphasize the special dangers of this middle range. See, for example, Walter (2022).

that its interests cannot or will not be taken into account under the current governing arrangements.[19]

In addition, elections tend to worsen problems of factionalism and, as a corollary, encourage the proliferation of identity rules. The coalitions that elites form to compete in elections are typically called political parties, but they are really assemblages of factions, and they are riven by divisions and prone to collapse. To put together the majorities they need to win elections, party leaders must promise specific benefits to each faction in their coalition, which means that, if the party wins, it must manipulate the economy to ensure there are enough rents to fulfill the bargains. These coalitions, moreover, are difficult to hold together from election to election because groups dissatisfied with their share of the spoils can easily defect to another party that is eager to bid them away, or they can form a competing organization and try to build their own coalition. Hence in electoral democracies characterized by identity rules, parties form, dissolve, and reform, and elites dissipate state resources and impede economic development in the ongoing effort to hold their coalitions together.

Democratic elections can thus be doubly detrimental to economic growth. On the one hand, the combination of identity rules and elections inhibits capitalist enterprise by exacerbating rent-seeking. On the other, the greater instability that results from the introduction of elections itself dampens growth. As Stephen Broadberry and John Wallis have shown, countries with more unstable polities also experience more frequent and more intense episodes of economic shrinking over time. Such shrinkages are a major cause of the low rates of economic growth that characterize so much of the Global South today. As a result, they help to explain the lack of a

[19] Walter (2022); and Wimmer (2013).

relationship between per capita income and a country's Polity Score below the set of rich advanced democracies.[20]

## 4. Impersonal Rules and Advanced Democracy

As the so-called "pluralist" school of political science recognized as long ago as the 1950s and 1960s, politics in a given country tended to stabilize whenever the multiplicity of factions that characterized its early democracy gave way to a small number of consolidated, long-lived parties capable of accommodating diverse interests within their organizations.[21] The key to this development, we argue, was the shift from identity rules to impersonal rules. This shift changed the incentives that political actors faced in ways that facilitated the emergence of consolidated political parties. It also changed incentives in ways that helped to perpetuate the new political arrangements.

The immediate effect of the shift to impersonal rules was to reduce factionalism. The disappearance of identity rules and the rents that they created meant that it was no longer a simple matter for political leaders in one coalition to bid factions away from another. Nor was it easy for new parties to attract support by offering those who would join them a greater share of the spoils of victory. Although new parties might still form for programmatic reasons, the rewards to defecting from an existing party would shrink relative to the benefits of staying and

[20] Broadberry and Wallis (forthcoming 2025).

[21] The preface to Dahl, ed. (1966) is an excellent introduction to this literature, as are the book's case studies. See also Lipset and Rokkan, eds. (1967). Case studies in this tradition include Rustow (1955) and Lijphart (1968). In recent years, political scientists have increasingly returned to this view, and it is common now to emphasize the importance for democratic development of consolidated political systems in which same parties compete against each other year after year, developing broad programmatic identities to cultivate voters' loyalty. See Kuo (2018), McCall Rosenbluth and Shapiro (2018), Ziblatt (2017), Berman 2019), and Hicken (2009).

working to reshape its agenda. Political stability would thus increase as the number of parties declined and those that remained consolidated their organizations and achieved greater permanence.[22]

In regimes governed by impersonal rules, interests still had an important role to play in politics, but it was fundamentally different from their part in regimes governed by identity rules. Under identity rules, most laws were tailored to the needs of specifically named individuals, groups, organizations, or localities, and are the result of bargains among elites. Under impersonal rules, by contrast, laws apply uniformly to everyone, or at least to everyone in the relevant categories. Although one individual or group may benefit from a proposed law, others will as well, and still others may be harmed. As a result, those that expect to benefit and those that expect to be harmed have incentives to organize for and against the legislation and, in cases where the issues involved are likely to come up again and again, to form more permanent interest groups. These groups function very differently from the factions that disrupt early democracies. Their ability to secure their legislative goals depends not on achieving political power in their own names but in influencing the agendas of the major political parties. In societies governed by impersonal rules, parties respond to the emergence of these organizations by developing distinct programmatic identities that enable them to attract the support and resources of groups in sync with their agendas. These identities matter because the policies the government enacts depend on the party that is victorious. Parties that win elections seek to establish a record of

[22] The US and the UK became two-party systems, but other countries (the Nordics are good examples) underwent the same transformation with multiple parties. Impersonal rules for forming parties allowed anyone to do so, but the number of major parties with reasonable expectations of winning elections, or of being in a governing coalition in proportional representation systems, declined significantly.

achievement on behalf of the interest groups with which they are affiliated, and as they do, they pursue policies that build the capacity of the state.

The greater stability that comes from the establishment of long-lived political parties has positive effects on the economy by eliminating the episodes of shrinkage that result from political disruptions. At the same time, the shift to impersonal rules makes the economic system more dynamic, more competitive—more capitalist. Once lucrative opportunities (and the organizational tools needed to exploit them effectively) are no longer restricted to favored members of the elite, capital, labor, and resources can flow to their most profitable uses. The shift to impersonal rules does not preclude restrictions on what the owners of capital, labor, and resources can do. Policy does not necessarily become laissez-faire. Governments can still regulate economic activities to promote the health and welfare of their populations, a more equitable distribution of income and wealth, or whatever goals the parties that win elections set on behalf of their constituent groups. Under a regime of impersonal rules, however, these regulations apply to all economic actors in the affected categories. Powerful members of the elite must follow them, just like everyone else.

These positive effects on political stability and economic dynamism have a self-perpetuating character that helps to ensure that the regime of impersonal rules will persist. Of course, politicians always face the temptation to exchange favors for political support and to alter the rules in ways that disadvantage their opponents. But the changes set in motion by the new regime create countervailing forces that decrease the likelihood of significant backsliding. In the first place, the greater competitiveness of the economy means that there are now more firms with wealth and power in a position to challenge any effort to give advantages to their rivals. In other words, competition creates interests that are vested in defending the impersonal rules that sustain

competition. Interest groups too can be counted on to mobilize against the award of special privileges that disadvantage their members; the more valuable the privileges, the more likely that multiple groups will mass together in protest and block the measure. In addition, consolidated political parties have long time horizons that give them a stake in maintaining the regime of impersonal rules. Their leaders understand that the uncertainties associated with electoral democracies mean that, at some point, they are likely to lose control of the government to the other party, and they want to be able to come back again and win. If they change the rules for short-term advantage, they will give their rivals the means to make their come-back more difficult.

It is an open question how strong these forces in support impersonal rules are—whether they are enough to keep the temptation to backslide at bay. All we can say is that the first countries to adopt impersonal rules did so in the late nineteenth century. Over the ensuing century and a half, they have faced repeated challenges to their regimes of impersonal rules. So far, the forces that sustain these regimes have held.

## 5. The Transition to Impersonal Rules and the Emergence of Consolidated Parties

But how, in the first place, could a society change from identity rules to impersonal rules? What possibly could induce elites to relinquish the tools they had always considered essential for winning and holding on to power? In democracies characterized by identity rules, complaints about favoritism were ubiquitous. Although factions out of power campaigned on promises to reform the system, when they got control of the government they behaved in the same way. To do otherwise—to fail to reward the elites who played an essential role in their

success—was political suicide. As a result, the system was very difficult to change. How could elites risk giving up the ability to create the rents they needed to hold their coalitions together?

Viewed in this way, the transition to impersonal rules seems like an impossible proposition. And yet, it happened—in at least a few places. In this section, we examine the very different ways in which two societies—the United States and Britain—transitioned to impersonal rules in the nineteenth century. We then contrast their experience with that of Germany, where partial reforms did not go far enough to bring about the necessary regime change. In all three cases, the beginnings of democratization made the problem of factionalism more severe and exacerbated the use of identity rules for political ends. In all three cases, governments made initial, limited efforts to reduce the extent to which politicians could manipulate the economy, for example, by enacting general incorporation laws. That turned out not to be enough, however. In the US and the UK, the shift to impersonal rules went far beyond general incorporation, transforming both the polity and the economy in the ways described in section 4. In Germany, however, the process stalled, with dire consequences for democracy and, it turned out, for the world.

*5.1 The United States*

The United States was born a republic. It was also born an electoral democracy. At the time of the American Revolution, both the number of offices chosen by election and the proportion of the population that could vote were already high by world standards, and they would grow higher still. By the middle of the nineteenth century, most legislative and executive offices and, in many states, judgeships were chosen in competitive elections in which all adult

white males could vote.[23] At the same time, politics was becoming increasingly factionalized. Although textbook histories project our modern two-party system back on this early period, what the authors call parties were in fact little more than shifting coalitions of factions. And there were lots of them. At the height of the so-called second party system, in the state of New York alone the Democrats were divided into Barnburners, Hunkers, Hard-Shells, Soft-Shells, Free Soilers, Young Americans, Locfocos, and so on.[24]

As a quick glance at any legislative record from the founding era will reveal, identity rules played an important role in politics from the very beginning, and their importance only rose as the franchise expanded and the number of factions competing for power grew. Between 1830-31 and 1850-51, the number of pages of laws enacted by state legislatures nearly doubled, increasing from 12.6 thousand in 1830-31 to 21.3 thousand in 1850-51.[25] On the order of 80 to 90 percent of these bills were identity rules. That is, they benefitted specifically named individuals, groups, organizations, or localities, granting them pensions, divorces, corporate charters, banking privileges, and the like. The favors that legislators awarded to political allies through these bills provoked outrage. Factions that were out of power promised to root out this kind of corruption if they were elected, but they never did and instead similarly dispensed legislative favors whenever they were in power.[26]

[23] Keyssar (2000) and Engerman and Sokoloff (2005).
[24] Furniss (2019). For a trenchant critique of the idea that there were modern political parties in this period, see Shelden and Alexander (2023).
[25] To give a few examples, in New York they increased from 972 to 1,968, in Pennsylvania from 1,162 to 2,022, in Illinois from 218 to 534, in Kentucky from 468 to 2,086. The number of pages of bills enacted by state legislatures comes from the state session laws as listed on Heinonline, https://heinonline.org/HOL/Index?index=sslusstate&collection=ssl.
[26] Ireland (2004) and Lamoreaux and Wallis (2024).

In the 1840s, however, the process of change was jumpstarted by a major crisis in public finance in which eight states and one territory defaulted on their bonded debt. The crisis was a direct result of the system of private bills. In Indiana, for example, advocates of a canal across the middle of the state had loaded up their public works bill with lots of little projects to secure the political support needed for passage. These sweeteners raised the aggregate cost of the project and the amount the state had to borrow to finance it. When the bank that Indiana used to market its bonds defaulted on its obligations, so did the state, and the resulting political earthquake propelled an effort revise its constitution to prevent such catastrophes from recurring.[27] Among the top priorities of the delegates who assembled at the constitutional convention was to ban private and local legislation, and they delivered on that promise. The 1851 Indiana constitution prohibited the legislature from passing private or local bills in seventeen enumerated situations, banned special charters of incorporation, mandated that corporations could only be created by general laws, and, most significantly, required the legislature to enact general laws wherever possible. The change had a dramatic effect on what the legislature did. Instead of passing hundreds of laws in each session granting favors to specific individuals, groups, and localities, it concentrated on enacting a much smaller number of general laws that set the terms on which these privileges would be open to all. The number of laws enacted in each session fell from a range of 300 to 550 in the decade before the constitutional revision to around 150 in its aftermath. At the same time the percentage of the

[27] Indiana had sold roughly $5 million in state bonds to the Morris Canal and Banking company on credit. The bank was to pay the state $500,000 every six months until all the bonds had been paid for, but the bank defaulted in the summer of 1839. For details, see Wallis (2003).

laws that were general rose from about 10 percent of the total in the 1840s to half to two-thirds in subsequent decades.[28]

Few of the other states that defaulted in the early 1840s initially went as far as Indiana in mandating that all laws be general, though most revised their constitutions to prohibit special charters of corporations.[29] That reform was important for the capitalist development of the economy but was not in itself enough to bring about the new institutional equilibrium. However, the mandate that laws be general spread rapidly in the last third of the century. Almost all the new states that joined the United States included general law mandates in their first constitutions. Moreover, there was another wave of constitutional revisions in the 1870s in which most of the remaining states in the union adopted Indiana's comprehensive general law provision or something very similar. There were a few exceptions (mainly in New England), but by 1900 impersonal rule provisions were pervasive in the United States.[30]

Why the 1870s? Factionalized political systems are always unstable but worries about instability seem to have reached a peak in the aftermath of the Civil War, when a resurgent South was endangering the achievements of what had been an extraordinarily bloody struggle and even threatening renewed conflict. In a broad swath of states stretching from the Middle Atlantic to the Middle West, the dominant Republic Party found itself facing rising competition from Democrats sympathetic to the South and, at the same time, internal divisions serious enough to

[28] Lamoreaux and Wallis (2021).
[29] Many also prohibited their legislature from granting divorces and the privilege of running lotteries.
[30] Lamoreaux and Wallis (2021). The general law mandates in these constitutions changed the norms for how legislatures should operate and affected practice in the few states that did not add general law provisions to their constitutions. There was no federal constitutional amendment mandating that laws be general and uniform, but Congress eventually codified the new norms in 1946 in the Administrative Procedures and Legislative Reorganization Acts. See McKinley (2018).

hobble its ability to respond to this threat. We have studied the turmoil in Pennsylvania and found that, by the late 1860s, Republicans of all stripes had come to the realization that special legislation was fueling the factionalism that undermined their ability to hold power. Concluding that the only way to save their party was to follow Indiana's example (Indiana's Republicans were noticeably less divided), they spearheaded a move to call a constitutional convention for the sole purpose of adding a general law mandate to the state's fundamental law. Their effort to revise the constitution was successful, and they were able to use the reform to repress factionalism. Not only did the imposition of a general law mandate alter the way in which the legislature conducted business, but the Republican party was able to consolidate its organization and dominate the state's politics for decades to come.[31]

Something similar occurred in other states that revised their constitutions during this period, though sometimes it was the Democrats who benefited rather than the Republicans. In almost every case the reform led to a dramatic fall in the volume of laws, as legislatures devoted their time to enacting a much smaller number of general statutes.[32] Because general laws were broad in their effects, it was much more difficult to put together the majorities needed to pass them. Log rolling was still possible, but once all the bills in a legislative package had to be general, the added measures were as likely to exacerbate the problem as to build a majority for the bill. The key to cutting this gordian knot was the emergence of consolidated political parties that the ban on private bills made possible. Thanks to their longer time horizons, parties could work out legislative deals that played out over the long run.

[31] Lamoreaux and Wallis (2024).
[32] Lamoreaux and Wallis (2024). On the emergence of dominant political parties in most states, see Hirano and Snyder (2019, Ch. 2).

There were several ways in which the ban on special bills facilitated the development of such modern parties, some of which were immediately apparent, others of which took longer to manifest themselves. In the short run, the ban stripped local politicians of an important source of goodies to dispense within their jurisdictions, making other sources of favors, such as patronage jobs, which were centrally controlled relatively more important. In Pennsylvania, this shift gave Simon Cameron, the state's lone Republican US senator, an initial advantage. So long as the Republicans controlled the White House, Cameron (and later his son, Donald, who succeeded him as senator) controlled the distribution of federal patronage in the state, including more than 200 positions at the Philadelphia customhouse and thousands more at the state's 3,000 plus post offices (the Philadelphia post office alone employed nearly 450 people).[33]

These short-run advantages could become sources of long-run dominance if the parties that benefited from them went on to develop programmatic identities that attracted the new interest groups that the shift to general laws also called into existence.[34] Large-scale businesses might have enough resources to lobby on their own, but small- and medium-sized enterprises had to join forces to advocate for the laws they wanted—laws that often conflicted with those that big businesses sought. In Pennsylvania, for instance, small-scale oil producers united to counter Standard Oil's dominance with a fair degree of success.[35] At the same time, voluntary associations for farmers and workers mushroomed into massive organizations that gave heft to what Elizabeth Clemens has dubbed a new and powerful "people's lobby."[36] In the 1890s,

[33] Harrison (1982, pp. 160-61).
[34] Lamoreaux and Wallis (2024). For a related argument, see Kuo's (2018) discussion of the shift from clientelist to programmatic political parties.
[35] The producers financed a *quo warranto* suit that Pennsylvania's attorney general brought against Standard Oil and used the state's partnership association law to keep Standard from picking them off with acquisitions. Destler (1967, pp. 83-193) and Lamoreaux (2015, pp. 53-54).
[36] Clemens (1997).

Pennsylvania Democrats sought to revive their fortunes by aligning with agricultural interests, but their opposition to tariffs hurt them with the state's labor movement at the same time as their embrace of inflationary policies did little to increase support. By embracing both gold and the tariff, Republicans were able to position themselves as the party of industrial prosperity and thereby secure support from both business and labor.[37]

Around the turn of the century, the two major parties were able further to entrench their dominance with the passage by most state legislatures of electoral reforms such as the Australian ballot, stricter voter registration laws, and the requirement that party candidates be selected in primary elections. Although these general laws have conventionally been ascribed to progressives who targeted party practices they regarded as corrupt, the effect of the laws was to strengthen the major parties, not weaken them. As Shigeo Hirano and James M. Snyder have shown for the case of primaries, the process of enacting the new electoral procedures was partisan. The reforms enacted tended to favor Democrats when they were adopted by states with Democratic administrations and tended to favor Republicans when they were adopted by Republican states. Similar patterns have been documented for the Australian ballot and Anti-Fusion laws.[38] Although the new laws were initially enacted for partisan purposes, they were not reversed when control of the state switched to the other party, and instead became a permanent part of the electoral rules that both parties sustained. Once the political system stabilized around two major parties that would be around to compete against each other election after election, it was to the advantage of each to commit to a consistent set of election rules, and to the regime of general laws that underpinned them. Party officials knew they would lose some elections, but

[37] Rathgeber (1956), Lyons, (1965), and McCaffery (1993, Ch. 4).
[38] Hirano and Snyder (2019). See also Alston, et al. (2018).

they also knew that when they did, they would return to power again in the future. Whatever temptation there was to undo the rules for short-term advantage was undercut by the realization such a move would empower the opposition to do likewise.

Some scholars have described the new electoral regime as antidemocratic, and certainly it altered the way voters related to the political system. Whereas politics in the late nineteenth century had been a participatory sport, now voters found themselves in the position of spectators, and many lost interest and stopped voting altogether.[39] However, although turnout dropped, so did electoral violence and corruption. The party system stabilized around two major parties, one dominating in some places and the other in other places, with control of the national government shifting from one to the other from time to time.[40]

As the political system stabilized, governments at all levels spent more money on public goods and took on a wider range of functions. In Pennsylvania, the state legislature poured resources into schools, hospitals, asylums, penitentiaries, and other public goods. It also developed the state's capacity to regulate corporations, banks, and railroads, and to assume new administrative functions through the creation of the agencies such as the Bureau of Labor Statistics, the office of Insurance Commissioner, the Superintendent of Public Instruction, and more.[41] These investments were another way in which the political stability made possible by general laws had positive feedback effects on the economy.

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[39] Kornbluh (1999) and McGerr (1986).

[40] Grinspan (2021). Hirano and Snyder (2019, pp. 10-15) have shown that two-party competition was a national phenomenon rather than a state characteristic. They defined a state as uncompetitive if the eight-year moving average between the Democratic and Republican vote shares differed by at least 15 percentage points. Even by this rather extreme definition, 28 out of 45 states (62 percent) were uncompetitive in 1904.

[41] Davies (1992). On the growth of state capacity in the area of antitrust, see Lamoreaux (2023).

*5.2 Great Britain*

In the early nineteenth century, Parliament's main business, like that of the US state legislatures, was the enactment of private and local bills. Indeed, the states had inherited this practice, along with other British institutions, from their colonizer. Over the course of the century Parliament gradually curbed the passage of such special bills. The restrictions were not constitutionalized as in the case of the US, or even explicitly formulated as a guiding legislative principle, but the change was nonetheless momentous and permanent. And it had similarly transformative effects on the economic and political systems, making the former more competitive and the latter more stable. By the late nineteenth century, the factionalized politics of the mid-nineteenth century had largely disappeared, and the political system was dominated by two major consolidated parties, the Conservatives and the Liberals.[42]

Although the transformation and its outcomes were similar in the two countries, the processes by which they occurred were very different, as was the timing of the change in relationship to democratization. The franchise expanded much more slowly in Britain than in the United States. Although a major reform bill enacted in 1832 fundamentally changed the electoral landscape by reallocating parliamentary representation to better fit the distribution of population, it only marginally increased the franchise. A second reform bill in 1867 made further improvements along the same lines, but as late as 1880, only about a third of the adult male population was eligible to vote. That proportion doubled after a reform bill enacted in 1884, but

[42] Hoppit (2017); Muir (1935, Ch. 6). It is important to be aware that the word "public" was not synonymous with general in legislative records from the early nineteenth century. In the US, state legislatures often published two volumes a year—one for private laws and one for public laws, but most of the laws in the public volume nonetheless applied only to specific individuals, groups, or localities. In Britain private laws were those that originated in a petition from an external party, who often paid fees to secure passage; public laws were introduced by MPs. Again, most of the public laws targeted specific individuals, groups, or localities.

universal male (and then female) suffrage awaited the First World War.[43] Moreover, although it was generally the case that the party that won the most seats in Parliament controlled the government, that principle was sometimes contested. It became more firmly established over the course of the century, alongside the shift to impersonal rules.[44]

One effect of the 1832 reform bill was to increase the power of the business elite in Parliament at the expense of the gentry. Businesses had been chafing under the monopolistic privileges granted to a few "monied" corporations, such as the East India Company and the Bank of England, and they had long pushed Parliament to strip those enterprises of their monopolies.[45] They were eventually successful, but securing a corporate charter still required a special act of Parliament, which was very difficult to get. Although businesses often tried to operate as corporations without securing charters, this strategy potentially ensnared them in legal difficulties. Their growing clout in Parliament paid off, however, and they secured legislation that made the corporate form available by a simple registration process—without limited liability in 1844 and with limited liability in 1856. These measures freed large sectors of industry from government controls on entry, permitting capitalist enterprises to flourish there.[46]

Identity rules still prevailed in other areas of economic and political life, however. Indeed, the effect of the 1832 reform bill, much like the expansion of the franchise in the US, was to increase the competitiveness of elections for Parliament and thus the incentives for Members of Parliament (MPs) to use their office to distribute favors to elite constituents. MPs flooded Parliament with private bills conferring on specially named people charters for local

[43] Flora, et al. (1983, pp. 91-93, 148-151).
[44] Kuo (2018, pp. 94-95) and Cox (1987, p. 10).
[45] Bogart (2017), Broz and Grossman (2004), Fichter (2010), and Lamoreaux (2016).
[46] Freeman, Pearson, and Taylor (2012), Harris (2000); Guinnane, Harris, and Lamoreaux (2017).

railroads, utilities, and the like. Control of the government seesawed between the two most important parties, the Liberals and the Conservatives, but neither organization was able to exert much discipline over its members. Indeed, the period is known as the golden age of the back benchers, because individual MPs concentrated on bolstering their local bases of support and voted for whatever they thought was in the interests of their district and their own reelection. After Sir Robert Peel pushed a bill repealing the corn laws through Parliament in 1846, the Conservative Party split so seriously that it faced the possibility of extinction, much like the Republicans in Pennsylvania in the years following the Civil War.[47]

By the mid-1840s, the flood of private bills was threatening MPs' ability to deliver favors to their constitutions in a timely way. In the case of railways alone, the number of bills presented for consideration jumped from about 150 per session in the late 1830s to more than 600 in 1846. Parliament convened a series of committees to consider the problem, and a consensus developed over the course of the 1830s that the solution was to enact a series of "clauses consolidation acts" to standardize the content of the private bills enacted for specified purposes. Over a short two-year period from 1845-1847, Parliament enacted many such acts: for railroads, waterworks, gasworks, companies, harbors, docks and piers, markets and fairs, cemeteries, police, and a variety of other areas in which private legislation was common. The clauses consolidation acts did not prevent MPs from doing favors for their constituents; to the contrary, they made the system of private bills more efficient. But the acts nonetheless moved the country toward impersonal rules by insuring, for example, that railroads would all operate under the same set of regulations. It was no longer easy, and perhaps not even possible, for businesses to secure

[47] Kuo (2018); Cox (1987).

especially favorable charter provisions with the help of their MPs. They could benefit from their aid in securing a charter, but the charter would be the same as everyone else's.[48]

The same press of business forced Parliament to grapple with the problem of dividing floor time between bills proposed by ministry, which was usually controlled by the party that won the most seats in Parliament, and bills introduced by rank-and-file members. Procedures worked out early in the nineteenth century allocated the two different kinds of business to different days of the week, which in practice came to mean that a couple of days each week were devoted to members' business, but otherwise the government controlled the agenda. Because members' bills were usually not of interest to anyone but the members involved, sessions on those days were increasingly poorly attended, and the ministry often encroached on them. The process was a gradual one, but by the end of the century MPs' access to the agenda became limited to twenty Fridays a year, and sometimes not even that.[49] Although the encroachments were not uncontested, the gradualness with which they occurred mitigated conflict and facilitated the reorganization of the political system. The factionalism of mid-century gave way two major consolidated parties, the Conservatives and the Liberals, each with its own programmatic identity. With their ability to dispense favors to constituents curbed, MPs were increasingly beholden to the central party organization for the resources they needed to secure reelection. And the voters they courted cared less about them as individuals than they did the ideas and programs that their party stood for. MPs' fate was tied to that of their party.[50]

By 1900 private bills had almost completely disappeared from Parliament's record, and Britain had transformed itself into a society governed largely by impersonal rules without ever

[48] Williams (1948), Vol. 1, Jennings (1969, p. 463), Foreman-Peck and Hannah (2016).
[49] Jennings (1969, esp. Chs. XI and XIII) and Muir, (1935, Ch. VI).
[50] See especially Cox (1987, Ch. 6).

formally legislating the change. And yet the result was as durable as the constitutional shift to general laws mandated by most the US states, and for much the same reason: because it transformed the economic and political institutions of society in ways that reinforced the new regime. In particular, the consolidation of the political system around two major political parties created organizations with an ongoing interest in preserving the regime of impersonal rules—of making sure that when they lost an election in the future, they would not also lose the chance to regain power.

*5.3 Germany*

The comparative cases of the US and UK highlight the divergent paths that even societies that shared a common legal tradition might follow as they negotiated the transition from identity to impersonal rules. In the mid-nineteenth century, both the US and UK enacted general laws that gave businesses ready access to the corporate form, and they both later expanded the scope of such impersonal rules to include most areas of law. This expansion occurred in very different ways in the two countries (and even in the various US states), but it was what made it possible for these nations to become advanced capitalist democracies. As a comparison with the case of Germany shows, merely opening access to the corporate form was not enough to bring about the political changes needed for this transformation. Germany adopted impersonal rules for forming business corporations circa 1870, but the rules did not spread into other areas of the law, and Germany's electoral democracy remained factionalized until it collapsed with the rise of Adolf Hitler and the formation of the Third Reich.

Until the late nineteenth century, businesses in the various German states needed the permission of their governments to form corporations. This system began to break down when some of the states competed to attract business investment by granting corporate charters more

liberally than others, and it collapsed after 1861 when most of the states adopted a common code of business law that permitted them to enact general incorporation laws if they chose. Prussia's North German Confederation enacted a general incorporation statute in 1870, which became Reich law with the unification of Germany in 1871.[51] This liberalization did not, however, carry over to other kinds of organizations, or more generally into the legal system. Indeed, until the turn of the century German law severely restricted residents' right to associate without explicit permission. Just holding a meeting without authorization could result in criminal penalties.[52] The dangers were very real—so much so even purely economic organizations like credit cooperatives feared harassment and clamored for the extension of organizational rights to their associations.[53] The move toward impersonal rules that general incorporation represented, moreover, was undermined by other actions the government took to legalize cartels. Germany allowed businesses to form corporations at will, but it also allowed associations of corporations to reach intra-elite agreements that the state would enforce. The cartels were essentially bundles of identity rules that enabled businesses included in the arrangements to earn rents. They could effectively limit entry in their industries, and many did. By the time the Nazis came to power in the 1930s, large swaths of the German economy had been effectively monopolized with the approval and assistance of the state.[54]

In the period following unification, Germany took steps toward democratization, and the franchise expanded to include most adult males. Although the country's chancellor was not chosen democratically, and voting was weighted to give the wealthiest property owners

[51] Guinnane, et al. (2007, p. 697).
[52] Guinnane and Brooks (2017).
[53] Guinnane (2020).
[54] For histories of German cartels, see Webb (1980), and Crane (2020).

significant advantages, turnout for elections to the Reichstag was high.[55] But the political system remained factionalized and became steadily more so over time as the number of parties proliferated. By the 1890s the conservative bloc that had supported Chancellor Otto von Bismarck—itself composed of three of the larger parties—no longer commanded even a third of the seats in the Reichstag.[56] As Daniel Ziblatt has shown, the government was forced to rely for its majorities on deals with local elites who dominated their areas through a combination of patron-client favoritism and outright repression and fraud. In exchange for their support, the central government showered local leaders in its coalition with infrastructure spending and other benefits.[57]

In Germany, as in other countries where elites continued to organize themselves using identity rules, consolidated political parties failed to emerge. Instead, as factions continued to proliferate and to combine and recombine in shifting coalitions, the political system showed increasing signs of instability. Rumors of coups and threats of uprising periodically swept the country from the late nineteenth century on. Sometimes they were more than threats, and in the 1930s, the Nazis took over.

## 6. Capitalism and Democracy

We have written more about democracy in this essay than about capitalism. In large measure this is because we have defined capitalism in a way that makes its development a direct

[55] Flora, et al. (1983, pp. 112-120) and Berman (2001). See also Anderson (2000).
[56] Berman, (2001, pp. 446-49). Berman has argued that relaxation of restrictions on associational life in the twentieth century further contributed to this fragmentation. See Berman (1997).
[57] Ziblatt (2017, esp. Ch. 6) calls these local leaders caciques to connect the German pattern with similar factionalism in Spain, Portugal, Italy, and France in the same period and also in Latin America.

consequence of the achievement of impersonal rules. But it is also because this achievement was part and parcel of the development of a new kind of political system that we call advanced democracy. Most political systems cannot deliver the impersonal rules that enable capitalism to thrive. Instead, elites depend on identity rules to achieve short-run political stability; that is how they create the rents that make maintaining the peace worthwhile, at least for a time. Introducing democratic elections in such societies does nothing to obviate such manipulations. To the contrary, as we have argued, the immediate effect is usually to worsen problems of factionalism, to increase the necessity of resorting to identity rules, and thus to exacerbate the economic distortions these rules entail. In such societies, therefore, the answer to the question of whether capitalism and democracy are reconcilable must sadly be no. Capitalism cannot thrive in polities where the pressure to hold factions together leads elites to manipulate the economy for political ends—where some elites gain access to profitable opportunities that are closed to everyone else. But neither are these polities likely to remain democracies. Prone to instability, their fate is often to slide back into autocracy.

Everything changes, however, in societies where the rules are impersonal. There the answer to the question of whether capitalism and democracy are reconcilable is a resounding yes. Capitalism thrives where opportunities that are open to some become open to all. Democracy thrives as well where factions give way to consolidated political parties whose longer time horizons give them a stake in the long-run stability of the political system. Getting from one equilibrium to the other is not easy, however. Only a relatively small number of countries have managed it—the rich advanced capitalist democracies of today. Because these countries made the transition in such different ways, their histories do not offer clear lessons that other countries can follow to become advanced. However, we can draw a couple of insights from the experience

of two countries we have studied that successfully negotiated the transition—the United States and Britain. First, for idiosyncratic reasons, elites in these places responded to the increased instability associated with early democratization by making changes that they perceived to be in their interests but that had the effect of increasing the impersonality of the rules under which the society operated—first in the economic realm and then more broadly. Second, once these changes were in place, they had effects that were not idiosyncratic but common across all the countries that adopted impersonal rules. The emergence of durable consolidated political parties and party systems changed the operation of the political system in ways that made the new regime of impersonal rules sustainable over the long run.

Advanced democracies are societies in which open debate about the rules is an inherent part of the political process. One of the inevitable dimensions of debate is how "capitalistic" the rules should be—that is, how promotional versus how redistributive. What can easily be missed in all the heat generated by these discussions is that capitalism does not require low taxes, a small government, or rules that benefit the wealthy. What it requires are agreed upon rules that apply equally to everyone in the relevant categories. That is the kind of equality that matters to economic development, and it matters to political development as well. Democracy and capitalism are both threatened by identity rules. Their productive reconciliation depends on the achievement of impersonal rules, and we are more likely to maintain both peace and prosperity if we better understand this relationship.

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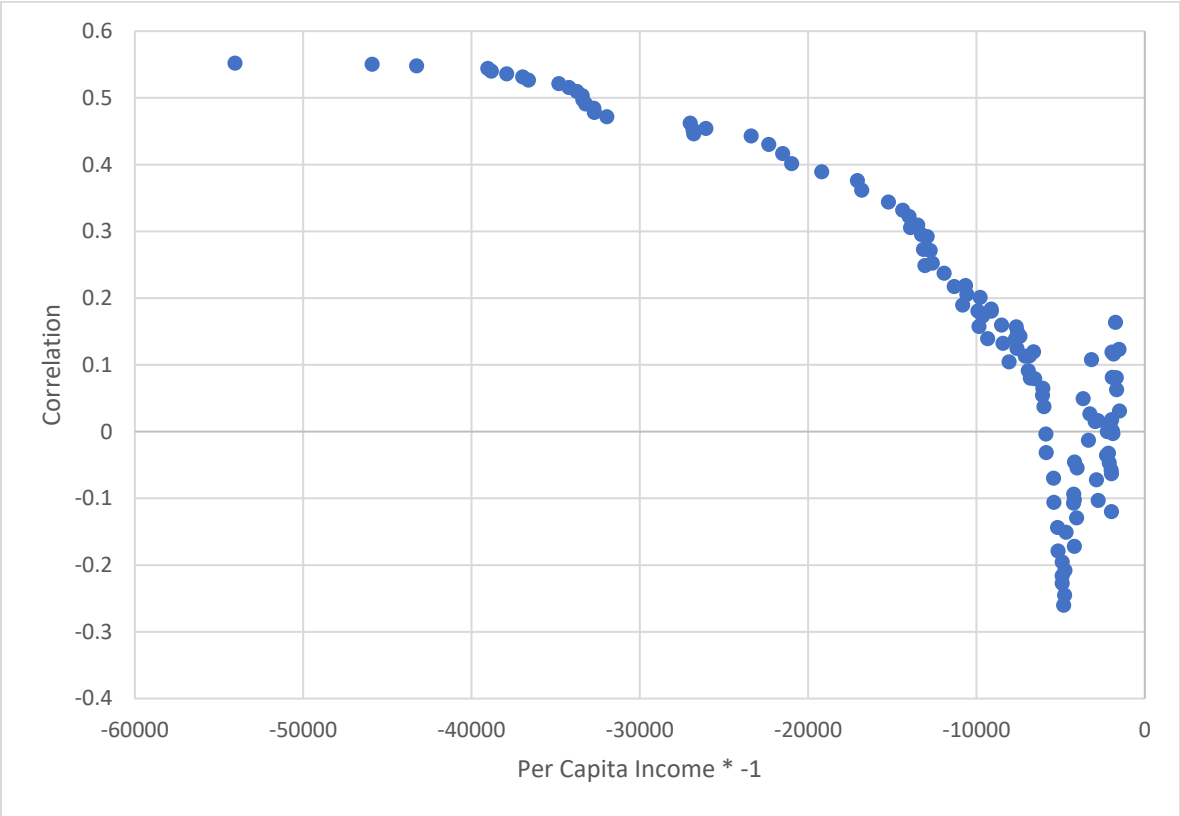
Figure 1

Correlation between the Polity V Score and Per Capita Income in 2000,
From $50,040 to $1,485

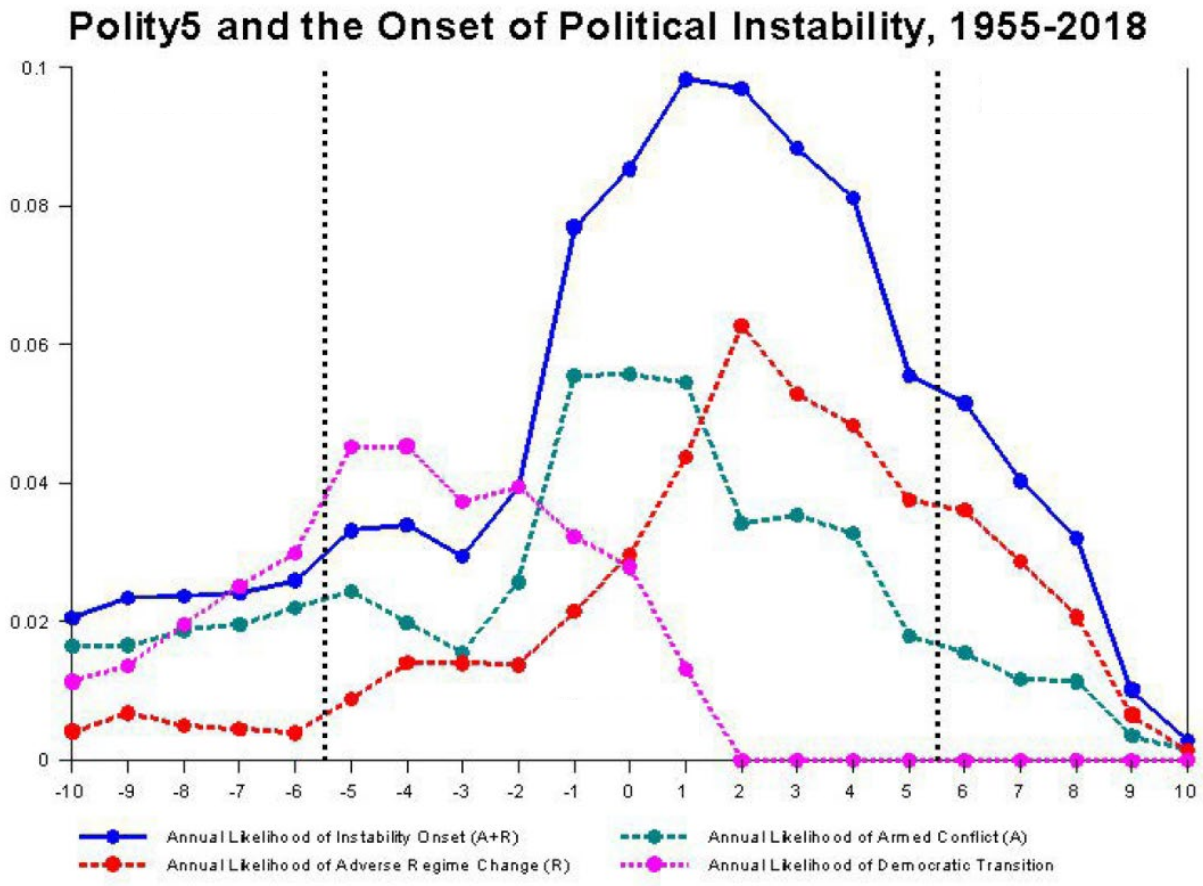



*Sources*: See Table 1.

*Note*: The figure reports the correlation coefficient between real per capita income and the Polity V score for 132 countries in 2000. Each point in the figure represents the correlation coefficient for a different sample of countries. The first point on the left is the coefficient for the entire sample from Norway to Afghanistan, excluding the specialized Middle Eastern oil producers. Each point to the right drops the richest country from the sample. The last point is the correlation coefficient for the poorest 27 countries from Bangladesh to Afghanistan. The horizontal axis has negative numbers to make it easier to see how the correlation between democracy and per capita income declines as rich countries are dropped.

Figure 2

The Relationship between Democratization and Political Instability




*Source*: Center for Systemic Peace, https://www.systemicpeace.org/polityproject.html.

*Note*: The vertical axis measures the likelihood that an unstable event will occur in a given year. The horizontal axis measures the country's Polity V Score.

Table 1

Cross-Country Correlations Between Per Capita Income and Polity V Scores,
Excluding Middle East Oil Producers, for 2000

| Subsample | Average Per Capita Income | Average Polity Score | Correlation Coefficient | p-value |
|---|---|---|---|---|
| Richest 25 countries | $33,094 | 9.80 | 0.22 | 0.10 |
| Richest 66 countries | $19,074 | 6.92 | 0.47 | 0.00 |
| All countries | $10,835 | 3.10 | 0.55 | 0.00 |
| Poorest 66 countries | $2,501 | 0.70 | 0.08 | 0.25 |

*Sources*: Per capita income (in 1990 Geary-Khamis dollars) is from Maddison, https://ghdx.healthdata.org/record/statistics-world-population-gdp-and-capita-gdp-1-2008-ad. The Polity V Scores are from the Center for Systemic Peace, https://www.systemicpeace.org/polityproject.html.

*Notes*: The tables include the 132 countries for which we have both per capita income and Polity Scores for 2000, not including the Middle Eastern oil producers Bahrain, Kuwait, Saudi Arabia, Oman, United Aab Republic, and Qatar. The averages are unweighted. If the oil countries are included in the sample, the relevant correlations (p-values) become: Richest 25 countries, -0.14 (0.25); Richest 66 countries, 0.14 (0.12); All countries, 0.34 (0.00).