

## Endogenous Power and Crises of the Liberal Order\*

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### Abstract

The liberal order is conceptualized as an artificial public good of higher order associated with nondiscriminatory provision of first-order public goods such as security and stability of possession. Problems of the liberal order and of liberalism as a political force are explained as a combined result of political challenges endogenously emerging in the economic sphere (including modern phenomena such as incomplete contracts, network externalities, and asymmetries specifically relevant in the digital economy), intertwined with problematic political reactions. There is no robust algorithm for coping with ensuing vicious circles of economic power and shadow politics, due to the intricacies of institutional adaptations required for maintaining the basic architecture of the liberal order under changing circumstances. Conclusions are offered with regard to current challenges of protectionist populism.

*JEL Codes: D72, H1, B00*

### 1. Entrepreneurship and the Freedom of the Moderns

Two hundred years ago, Benjamin Constant diagnosed a fundamental difference between modernity and classical antiquity regarding freedom. In a famous speech (*De la liberté des anciens comparée à celle des modernes*), he summarized his pertinent thoughts: “We can no longer enjoy the liberty of the ancients, which consisted in an active and constant participation in collective power. Our freedom must consist of peaceful enjoyment and private independence” (1819). Indeed, modern societies are characterized by private-individual freedoms extending far beyond what has been known in other societies. “Security in private enjoyment” is not limited to purely self-

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regarding acts, and it is complemented by contract-mediated private economic interaction under the rule of law. Freedom of contract, including employment and entrepreneurship, is the economic side of classical civil liberties that shape the horizon of individual actions, including consumer sovereignty as well as creative entrepreneurship and experimentation. The institutions of “high capitalism” à la Schumpeter promote entrepreneurial innovation up to “creative destruction.” This presupposes that traditional bonds restraining individual agency by way of custom, community, guild or stakeholder interests lost their grip to an extent that (as in Schumpeter 1912) the “banker” becomes the only veto player potentially blocking innovations by denying the would-be innovators access to the loans needed for practical implementation. The freedom of the moderns co-evolves with social norm systems becoming more innovation-friendly: the “experiments in living” (Anderson 1991) advocated by John Stuart Mill as part of liberal social dynamics illustrate this, but so does the dynamism of avant-gardes in the field of art. The development of private agency spaces moreover co-evolves with emergent patterns of unintended macro-consequences. Ultimately, therefore, the freedom of the moderns is related to the socio-economic-cultural dynamism of capitalism with its restless change in patterns of specialization and location, including the emergence and (de-)stabilization of norms and institutions – and concomitant political challenges.

While Constant’s stylization of ancient freedom may reflect philosophical idealizations of the *polis* with ambivalent historical grounding, his emphatic view of the “freedom of the moderns” is undoubtedly not taken from thin air. The following piece, however, deals with the problems that make it impossible to stop here: it would be wrong to conclude from Constant’s pointed argumentation on freedom in modernity that the question of political freedom should be put aside. In the latter part of his speech (and in other work) Constant himself brings to the fore specifically modern political challenges. As I will suggest in the following, those challenges are endogenous to the co-evolution of markets, politics and behavioral patterns, including the risk of an illiberal degeneration of the political sphere. Constant’s pertinent appeals are moving and reminiscent of the pedagogic emphasis on liberal civic spirit by his Swiss compatriot Gottfried Keller in “The Banner of the Upright Seven” (1861). While this liberal civic spirit is a typical part of suggested remedies (and not without reason, as I am going to explain), the diagnostic and analytical thrust of Constant’s pertinent arguments is part of a multi-faceted line of liberal thought, including Adam Smith, José Ortega y Gasset, and Joseph Schumpeter (1942), who stressed interdependences between economic and political systems, distortions of political agency and “perverse” reactions in the political system, putting the foundations of the liberal order at risk.

In terms of analysis, two questions need to be distinguished and addressed. Each of the questions is complex, including a lead question and a number of sub-questions.

(A) Why is the liberal order vulnerable, despite its widely acknowledged successes, and despite the fact that no attractive alternative is appearing on the horizon of

history? What are the indispensable – yet vulnerable – foundations of a liberal order? Why are parts of those foundations subject to systemic risk? Why is there no once-and-for-all solution for the stabilization of these foundations?

- (B) What are the grounds of eventual crises of “liberalism,” understood as a generic term denoting political forces devoted to the civilization mission of developing/preserving the liberal order? Are there reasons for a historical coincidence of crises of liberalism and the more dramatic moments of the instability of the liberal order?

The main parts of this piece offer a sketch of an answer to question A. In section 2, I will deal with the instability of the liberal order, focusing primarily economic factors giving rise to a “Medici vicious circle” of economic and political power. Section 3 discusses the foundational role of the specifically modern private-public divide in superseding privilege-based governance and coping with vicious circles. Section 4 deals with the difficulties inherent in the development of modern governance in a world of economic dynamism: there is no simple algorithm and no once-and-for-all institutional implementation of the basic principles of an open liberal order: trade-offs at the level of implementation of those principles are contingent upon changing challenges occasioned by the socio-economic-technological dynamism of capitalism, which time and again is triggering problematic forms of interpenetration of the public and the private as well as crises of the liberal order. Liberal principles are the basis of virtuous circles of openness and prosperity, but they do not provide an automatic safeguard against vicious circles of power and privilege emerging endogenously within this dynamism. Crises of *liberalism as a political force* are due to intricacies of political reactions to such tendencies, including a specific difficulty: assessing the proper implications of liberal principles (for institutional reform as well as for political strategies) under newly emerging challenges is by no means a trivial task. Considering this, section 5 offers some conclusions in view of current populist/protectionist challenges, addressing question B.

## **2. Endogenous Economic Power, Medici Vicious Circles, and the Instability of the Liberal Order**

Regarding the vulnerability of the liberal order (question A), I follow Constant in distinguishing political and socio-economic aspects. However, both aspects need thorough analysis in view of 200 years co-evolution of the complex of interdependent systems called “market society:” time and again, forces linked to the dynamism of market economies and the vicissitudes of civil societies trigger tendencies towards kinds of interpenetration of private and public sectors conducive to the mutual reinforcement of economic and political power (what Chicago economist Luigi Zingales, 2017, calls a “Medici vicious circle”). Agents possessed of rent-generating

market positions have *the means and the incentives* to secure rents by way of political activities influencing the rules of the game.<sup>1</sup> It is widely acknowledged that a prosperous liberal society will coincide with a minimization of unproductive rent-seeking, channeling entrepreneurial energies in a way such that temporary Schumpeterian innovation rents are the systemically dominating form of rents. However, the development of a liberal order along the lines of innovation-friendly principles entails more enduring challenges than is often acknowledged: (1) While well-defined private property rights play a crucial role for a liberal order, they need to be complemented by public institutions supporting openness and appropriate forms of procedural equality in a dynamic environment. Not any pattern of private property rights and not any mode of privatization is compatible with the development of a liberal political order, as illustrated by some episodes of privatization in the former Soviet bloc after the fall of communism (Sturm 1993 for a critical view of pertinent conclusions inferred from the Coase theorem). (2) The political counter-reactions to the oligarchic structures emerging from Medici vicious circles are ambivalent, possibly including illiberal forms of populism. (3) The systemic role of political influence activities may differ according to the specific nature of the rent-generating market position under consideration. In cases of rents which are specifically vulnerable to the risk of political expropriation (because conditions of nature and technology allow for expropriation with little rent dissipation, and/or because the legitimacy of property titles is considered questionable), there are particularly strong incentives for purely status-preserving influence activities: a paradigmatic case is the so-called political resource curse (Vahabi 2017) where the rule of resource-exploiting oligarchs (or populists) undermines the development of an innovation-friendly institutional environment. (4) Even in a progressive economic context where temporary innovation rents are systemically relevant, agents may consider political influence activities (a) a substitute for or (b) a complement to further Schumpeterian innovation, depending on techno-economic properties of the technologies dominating the respective cycle of innovation on the one hand, and the current state of evolution of the political system on the other. Understanding pertinent conditions for liberal prosperity is hence associated with answering three kinds of questions:

- I. *Economic analysis.* What are the determinants of the currently prevailing rent-generating market positions? How are they related to “natural,” technological, economic and political factors? How are those factors affected by current developments/innovations in the respective areas?
- II. *Institutional analysis.* What are the specific requirements for making effective the principles of the liberal order coping with vicious circles of economic and political power? These principles include well-known rules, balances and power-

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<sup>1</sup> As stated by Zingales (2017, 119): If the ability to influence the political power increases with economic power, so does the need to do so, because the greater the market power a firm has, the greater the fear of expropriation by the political power. Hence, the risk of what I will call the “Medici vicious circle.”

divisions of an open-access order, politically embedding a stable, but innovation-friendly system of well-defined private property rights. Drawbacks of systems lacking such a proper embedment (Zingales 2017; North, Wallis, and Weingast 2009) are often ignored by constitutionally naïve views of privatization (Sturm 1993). The effective working of such an order typically (a) requires the historically contingent implementation of power-constraining regulations, with specificities depending on the current stage of economic/technological development,<sup>2</sup> and (b) hinges upon private and public governance institutions channeling rent-seeking behavior in a way fostering Schumpeterian innovation and limiting the scope of unproductive or destructive rent-seeking.

- III. *Agency*: Who is going to implement the institutional adaptations required for making effective the basic principles of this order under changing circumstances? What about the agency capabilities of the political sphere? To which extent are they attenuated or perverted by the effects of the currently prevailing forces of the Medici vicious circle? To which extent can the forces of civil society and of political competition be relied upon to make the state an effective agent promoting the public interest? Are those forces distorted by excessively fragmented interest groups and destructive forms of political competition? Is the vicious circle accompanied by anti-pluralist and protectionist forms of illiberal reactions against power elites (“populism”) promoting cures which are worse than the disease?

In terms of agency, addressing three related issues is crucial: first, adverse reactions in the political sphere cannot be exclusively attributed to periodic revivals of atavistic forces. They are related to current socio-economic developments. Calling for a simple and once-and-for-all panacea allegedly precluding the degeneration of the political sphere is hence a risky illusion. Second, spuriousness of such a panacea does not imply however that liberal principles are less important. The main thrust of the following argumentation suggests that liberal governance principles are the key requirements for identifying the evolution of trade-offs (or pragmatic priorities) in governance, thus making effective the specifically modern distinction between “private” vs. “public” spheres under ever-changing circumstances, and preventing or breaking new Medici vicious circles. Third, the institutional implementation of this distinction as the foundational element of a liberal order will (i) be associated with a complex multi-level architecture including important private-public interfaces and interactions and (ii) benefit from insights according to which the distinction between private and public life is not based on a clear-cut “objective” dichotomy, but on a multifaceted set of

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<sup>2</sup> Zingales’s account of the non-economic factors influencing the scope of the Medici vicious circle is a mix between basic principles of the liberal order and circumstances related to the level of implementation which may be contingent upon socio-economic developments. He identifies six factors: “the main source of political power, the conditions of the media market, the independence of the prosecutorial and judiciary power, the campaign financing laws, and the dominant ideology” (2017, 115).

overlapping contrasts (Geuss 2001), partly associated with normative assumptions and historically contingent norms.

It is particularly important to see why ignoring such complexities, notably including private-public interfaces and interactions, is “deceptive and misleading” (North, Wallis, and Weingast 2009, 147). Consider the idealized model of a fully competitive private-ownership equilibrium economy. It is a perfect theoretical starting point for a *neat* and *simple* private-public divide. In such a world, once the initial endowment rights are well-defined and enforced (by institutions of the public sphere), the welfare-enhancing coordinating potential of voluntary exchange will be fully exhausted – in a fully depoliticized market sphere,<sup>3</sup> never giving rise to “political” problems to be addressed by political modes of mediation (arguing, bargaining, fighting, voting). While patently unrealistic and misleading for practical purposes, the fully competitive model should not be altogether abandoned. As Schumpeter (1912) recognized, it serves as an indispensable benchmark in more than one way. It makes explicit the conditions of a world peacefully governed by the principle of free contract forever, leaving no room for rents and distributive struggles, or any other problems eventually calling for political mediation – thus preparing the scene for a simple and unproblematic private-public divide.

The endogenous economic forces with disruptive political potential hinge upon the widely acknowledged gap between models of fully competitive equilibrium and the dynamism of market economies. Over the centuries, prominent economists were not only acutely aware of economic power, but stressed that no easy once-and-for-all solutions are available: Smith’s warnings regarding the “wretched spirit of monopoly” (Kurz and Sturm 2013) and the critique of the interpenetration of public and private sectors in the interwar period culminating in ordoliberalism are just two examples. Pertinent discussions at the Colloque Walter Lippmann (CWL) were guided by the question of whether monopolistic tendencies were a result of the natural course of things (bringing about decreasing average costs) or the result of protectionist policies (Reinhoudt and Audier 2018, 119–126).

This discussion has been resumed in the digital age, including Zingales’s recent (2017) “political theory of the firm.” New technologies are supporting dynamically increasing returns to scale associated with specialization within “vertically serrated industries” in globalized value-chains, challenging traditional forms of anti-trust and competition policy: as summarized by Basu, digitalization is accompanied by increasing returns to scale which “are natural and not artificially induced” (2019, 1). However, what about the following question: Are the problems of monopoly caused by “natural” (economic/technological) factors, or are they the (intended or unintended) outcome of politics? This distinction cannot be taken for granted as the starting point of analysis when both aspects are intertwined. As anticipated by ordoliberalism and adjacent strands of literature in constitutional law and political

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<sup>3</sup> For various ways of dealing with such a sphere, see Lerner (1972); Nozick (1974); Weizsäcker (1999) and Bowles (2004).

economy (Sturm 2020a), pathological forms of politico-economic interdependence may enter onto the center stage.<sup>4</sup> Theoretical developments of recent decades allow for a better understanding of the ways in which economic power and rents are phenomena endogenous to the working of modern market economies including technological and socio-economic developments – and why this is a problem for the liberal order. The technological and socio-economic factors to be considered in combination include:

- (i) Digital “datafication” (big data and predictive analytics) supports new forms/cases of price differentiation and other forms of one-sided rent-appropriation.
- (ii) Digital technologies are associated with sunk costs, widespread network externalities, lock-in effects, and information complementarities. As summarized by Zingales: “The value of the data derived from Facebook and Instagram combined is likely to be higher than the sum of the value of the data derived from Facebook and Instagram separately, since the data can be combined and compared. Thus, Facebook is likely to be the higher-value user of Instagram data, even ignoring any potential market power effect. If you add market power effects, the momentum toward concentration might be irresistible” (2017, 121).
- (iii) Digitalization enhances the weight of information-intensive goods with high fixed and low marginal costs. This is conducive to the emergence of winner-takes-all industries.
- (iv) Lower transaction and communication costs allow for a quantum leap in dynamically increasing returns to scale associated with market-mediated globalized patterns of intra-industry specialization (i.e. “vertically serrated industries”; Basu 2019), changing the nature of monopolistic challenges.
- (v) Incomplete contracts (associated with rents and power) remain the rule rather than the exception, despite the potential of smart contracts.

Considered in isolation, most types of problems are not new. The advances of the internet and of social media are not the first case of network externalities; they have been crucial since the telephone. However, they exhibit a remarkable dynamism. Beyond that, specifically new combinations of those factors change the institutional architecture in which complete and incomplete contracts coordinate decentralized activities. While the secular modernization of contract governance brings about more complete contracts (Sturm 2017a), ubiquitous contract incompleteness is not a pre-modern phenomenon (Bowles 2004, ch.7): over the centuries, governance modernization led to more complete *and* a greater number of incomplete contracts. Block-

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<sup>4</sup> See Reinhoudt and Audier (2018, 124) for an impressive anticipation by Rüstow at the CWL. In the context of the digital economy, reduced antitrust enforcement may be an indicator of various kinds of problems, including: (1) partial obsolescence of traditional policy tools in view of digital monopolies, (2) economic nationalism, (3) tendencies of a Medici vicious circle. Anyway, there is a trend in that direction. “During the period 1970–1999, the Department of Justice and the Federal Trade Commission (FTC) together brought an average of 15.7 cases under Section 2. Between 2000 and 2014, they brought only 2.8 cases a year” (Zingales 2017, 120).

chain and smart contracts are further steps in the modernization of contract governance, but will hardly eliminate incompleteness.<sup>5</sup> Given incompleteness, rents function as incentive devices endogenously, promoting contract enforcement when exogenous enforcement is too costly or impossible due to the relevance of non-verifiable information.<sup>6</sup> In a broader politico-economic perspective, incomplete contracts are part of a setting of contested exchange (Bowles 2004) with endemic power-related phenomena, as Zingales explains:

“... emphasizing the incomplete nature of contracts and rules, the theory of incomplete contracts creates scope for lobbying, rent seeking, and power grabbing. The traditional contributions focus on the under- or overinvestments in firm-specific human capital, but the framework can easily be extended to the political arena. If rents are not perfectly allocated in advance by contracts and rules, there is ample space for economic actors to exert pressure on the regulatory, judiciary, and political system to grab a larger share of these rents (...) If the ability to influence the political power increases with economic power, so does the need to do so, because the greater the market power a firm has, the greater the fear of expropriation by the political power. Hence, the risk of what I will call the ‘Medici vicious circle’” (2017, 119).

In this environment, power-inducing structural conditions in the sphere of exchange may gain importance, including ones setting the scene for

- monopolistic/monopsonistic price/wage setting,
- take-it-or-leave-it offers (TILOs),
- first-mover advantages (“Stackelberg leadership”).

All this is incompatible with the view that new “unsolved political problems” never emerge in the private sector. To be sure, some accidental opportunity for a TILO need not be a political problem. However, if the ability of an agent making TILOs is determined by structural conditions, she will regularly appropriate the lion’s share of transaction surpluses, which *may* pose a problem, especially when interacting with a cumulative causation mechanism triggered by features such as network externalities.

Discussions at the CWL indicate awareness of the implications of the impossibility to build the case for the liberal order on the basis of a fully competitive economy: it strengthens rather than weakens the case for a liberal order, yet it does not make life easier for political liberalism. The developments of the past decades show multifarious ways in which rents endemic to the economic process imply politico-economic challenges which need to be addressed politically. As in previous cycles of innovation in the history of capitalism, their specific scope and combinations require rethinking some trade-offs and priorities associated with the implementation of liberal principles.

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<sup>5</sup> See Sturm (2020b) for a critique of perfectionist projections of technological remedies to contract incompleteness in governance ecosystems of the digital economy.

<sup>6</sup> Notice the kinds of economic rents discussed here are functionally related to the dynamism of market economies, implying that one cannot simply get rid of them by political fiat. However, the distributive effects going along with those rents (including the temporary innovation rents of Schumpeterian “creative destruction”) may trigger political backlashes.



Notice that such laborious exercises are redundant in a fully competitive economy: perfect competition demarcates the case where one can rely on a contract-mediated sphere of mutually advantageous transactions without any “vicious” political potential. It may be safely epitomized a depoliticized sphere – a sphere of solved political problems (Lerner 1972). Pertinent rules of the game could be implemented and maintained in a much simpler (perhaps technocratic) way. This serves as a theoretical benchmark case, but should not be mistaken as a background for developing regulating ideas of the liberal order.

### 3. Against Privilege: Liberal Order and the Modern Private-Public Divide

The *ancien régimes* preceding the emergence of the liberal order can be described as governance by an “aggregate of privileges” (using Hegel’s phrase) in a political setting where the architecture of private and public was incongruent with the demands of commercial society (Schumpeter 1942, 197). Limited access orders induced by such arrangements implied multiple veto-players retarding innovation. Joel Mokyr’s (2016) account of the *Culture of Growth* emerging in Post-Renaissance Europe shows the weakening grip of veto-players due to the institutionalization of Enlightenment values and the Republic of Letters. This development was accompanied by an evolution of governance reflected in Adam Smith’s (WN V) theory of *genuinely public functions* requiring a *specialized public governance agency*. Despite all the challenges stressed by Smith himself (overcoming the inertia of mercantilist governance as well as newly co-evolving distortions of political agency), the liberal order of the 19<sup>th</sup> century co-evolved with states strengthening credible traits of a truly public sector. The public sector thus emerged historically together with (and not in opposition to) a private entrepreneurial economy, which cannot prosper under a regime of veto-players: the entrepreneurial economy could become truly private (and individual freedom à la Constant could flourish) when the public sector became genuinely public – that is, a counter-model to governance by privilege, to governance crippled by the mutual interpenetration of private and public, and by amalgams of public functions and private interests. Well-defined private property rights are a starting point for the expansion of free exchange under a liberal order *with truly public governance*, which is needed for developing the required set of rules clearly demarcating the domain-specific distribution of veto power (and lack thereof!), protecting non-privileged individual freedom under conditions of socioeconomic dynamism. Those general principles have historically contingent institutional implications: e.g. Schumpeter (1918) stressed implications for the evolution of public finance up to World War I.

The challenge faced by liberal political governance can be summarized as follows: *How develop institutions/procedures/mechanisms of state agency which preserve its public character*, coping with powerful endogenous adverse tendencies? This chal-

lenge is dramatic, as modern governance cannot rely on mechanisms blocking those destabilizing influences once and for all. While a credible private-public divide is crucial, the co-evolution of public and private sectors is characterized by multiple interdependencies and interfaces (Sturm 2017b). Consequently, one ought to be concerned with the “*quality*” of those interfaces, such as taxation, debt, public procurement, private individuals entrusted with public tasks, and so on. Throughout the history of liberalism, the complex nature of pertinent challenges is reflected in various recurring aspects of its development:

1. Impartial competence is stressed as a core virtue of liberal policies, set against class-interest-based politics.
2. Liberal pluralism and versatility indicate that answers to pertinent challenges are contingent and contested, with pluralism being a resource for the resilience of liberalism.
3. Recurrent emphatic invocation of liberal civic spirit and “public awareness” (Zingales 2017, 129) is congruent with the message of Böckenförde’s constitutional analysis (1976, 60), stressing that constitutional frameworks and the rule of law are necessary, but not sufficient for stabilizing the liberal order.<sup>7</sup> The latter requires a civil society and a political system holding the public sector accountable as a provider of higher-order public goods. It is incompatible with a civil society which is nothing but a collection of rent-seeking groups.

Regarding constitutional principles, there are some broadly accepted necessary conditions: the rule of law and the division of powers in the context of a constitutional framework. Moreover, various additional elements have been suggested, such as institutionalized guardians (e. g. constitutional courts) providing stability in the case of crises, a suitable federal structure, a role for intermediate institutions, specific power-constraining rules, or certain kinds of social policy as suggested by some ordoliberals. However, neither *institutional structures* nor *constitutional safeguards* offer permanently reliable solutions regarding the stability problems of a liberal order, given challenges endogenously brought about by socio-economic dynamism. The foremost condition for coping with crises of the liberal order (and with crises of liberalism) is acknowledging that there can be no simple and permanent solution. The specificities of the answer to the question: How to cope with the challenges undermining the liberal order? are subject to contingencies occasioned by the paths of socio-economic evolution. Section 4 develops a framework locating the trade-offs occasioned by these contingencies.

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<sup>7</sup> Hayek (1960) and (in a more cryptic form) Schumpeter (1942) refer to various levels at which German language traditions analyzed dilemmas of modern governance. For more systematic sketches referring to that background, see Böckenförde (1976) and Sturm (2020a).

## 4. No Free Lunch, No Safe Side: Trade-Offs in the Evolution of Liberal Governance

A reader having followed the argument so far might say: I understand that economic-technological dynamism brings waves of new challenges, and that incomplete contracts are pervasive – and I understand that this is conducive to rents and economic power nourishing tendencies aiming at their entrenchment with the aid of the political system, posing problems for the liberal order especially in combination with network externalities, winner-takes-all industries etc. Nonetheless, minimal government robustly guarantees staying on the safe side: with minimal government, one can be sure that no additional rent-seeking potentials are created by Big Government redistribution, which make things worse. While minimal government may not reach the ideal of full neutrality (in view of the endogenous tendencies described), it is likely to come closer to it than any other form of government.

Unfortunately, minimal government fails as a universal rule *at the level of institutionalization* of a liberal order constitutive of an open society – not because there are superior rules, but because *at this level* no robust rules (beyond the defining principles of the liberal order) do exist in worlds where socio-economic dynamism profoundly affects the distribution of different types of choices. Let us start with the observation that there are private choices and collective choices in a technical sense. When Joan and Jill are offered a choice between chocolate and vanilla ice-cream, Joan may choose and get chocolate, while Jill may choose and get vanilla, according to their tastes. The same holds for T-shirts of different colors or materials and myriads of other trade-mediated private goods and inputs. Moreover, it holds for a second type of choices – choices regarding private spheres: while Joan may choose to sleep on her back (and paint the wall of her kitchen blue), Joan may sleep on her belly (and paint the wall of her kitchen pink).<sup>8</sup> In an analytical piece “On Liberal Values,” Christian Seidl (1975) calls such choices technologically separable.

In contrast, when Jill and Joan are offered the choice between Hillary Clinton and Donald Trump as president of the United States, and Jill prefers Clinton while Joan

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<sup>8</sup> Mill (1909 [1848], V.xi.) already distinguishes those two types of private choices: He starts his discussion of the limits of government interference with the principle of liberty regarding purely self-regarding choices: “... a circle around every individual human being which no government, be it that of one, of a few, or of the many, ought to be permitted to overstep: ... within which the individuality of that person ought to reign uncontrolled either by any other individual or by the public collectively.” However, *contract-mediated exchange* does not belong to this class of choices. Mill (*ibid.*, V.iv) stresses that “trade is a social act” and “in principle, comes within the jurisdiction of society.” With regard to contract-mediated exchange, Mill (*ibid.*, V.xi) famously claims that (in a reasonably well-ordered private ownership exchange economy) “the onus of making out a case always lies on the defenders of legal prohibitions” and “*Laissez-faire*, in short, should be the general practice: every departure from it, unless required by some great good, is a certain evil.” Allocating the onus of argument in this way is motivated *inter alia* by the competition-mediated advantages of widespread experimentation and mobilization of the dispersed intelligence and agency of the many.

opts for Trump, only one of them can expect to get her way, irrespective of the specificities of collective choice procedures transforming individual choices into outcomes. This observation may be extended to other cases, such as the choice between war and peace (Constant's favored example), monarchy and republic, or two different CO<sub>2</sub> concentrations in the atmosphere. Rules of the game typically belong to this class (in contrast to individual moves chosen under a specific game structure set by those rules). Seidl (1975) calls these choices technologically compound.

These observations are trivial. However, they trigger thoughts as to why different norms and institutional settings have developed around different contexts of choice. Norms of tolerance are relevant for publicly observable self-regarding choices, while markets and contracts are typically mediating choices which are not purely self-regarding, but technologically separable. Technologically compound choices are often associated with collective choice mechanisms. However, in neither of the cases do technological properties *logically* imply corresponding choice mechanisms. For instance, technologically compound aspects may be determined by informal norms, oracles, dictators, or the invisible hand: emergent patterns of the division of labor are a pivotal example. Network externalities, positive feedback and cumulative causation are some of the keywords indicating the scope as well as possible problems of pertinent cases. The socio-economic dynamism of market societies is associated with processes where public and private aspects are mixed: separability at the micro-level gives rise to private choices, but some important dimension of the aggregate outcome is technologically compound. This is illustrated by the well-known example of the theatre where a norm that everybody should remain seated during the performance collapsed. Of course, Jill is not formally obliged to stand up when Joan (for better view) stands up before her. However, if what matters is the field of vision (and all standing up is a unique best-response equilibrium), freedom of choice becomes spurious because the technologically separable aspect becomes irrelevant – as in the presence of strong and pervasive network externalities.

Key protagonists of economic liberalism (Smith and Hayek come to one's mind) explained why the working of the invisible hand is nonetheless part of the progress of improvement. Perfectionist technocratic reforms are unlikely to outperform the invisible hand in some cases of complex emergent patterns. Nonetheless, modern liberal societies experienced an evolution of mechanisms of explicit collective choice and public accountability. Associated with some degree of governance centralization, these mechanisms displayed a historically contingent potential for coping with governance by privilege and for developing rule systems allowing for a sustainable expansion of the scope of market-mediated choices. Consequently, one has to deal with three complementary *potentials associated with the progress of modern civilization – and their drawbacks, giving rise to the mentioned trade-offs in governance:*

- (1) The politico-economic potential of market-mediated “liberty of the moderns.”
- (2) The potential of explicit collective choice and public accountability.
- (3) The potential of centralization.

While coordination problems of great modern societies are unsolvable in societies where these potentials are altogether neglected, pushing each of the potentials to its limits is associated with fatal drawbacks. Analyzing them requires a closer look at the private-public divide characteristic for the liberal order and its marked contrast to mercantilist and feudal governance by privilege/exclusion. In a more than merely semantic reference to David Hume's "artificial virtues" (1739/40 III), I will call the liberal order an "artificial public good" of higher order. "Provision" of this good cannot be reduced to a single deliberate collective choice, but depends on a complex institutional mix including constitutional elements and a salient role of institutionalized public accountability. The properties of this order are the background of its vulnerability/instability. When the societal forces sketched in the previous sections push it away from the private-public divide necessary for supporting the order-preserving politico-economic equilibrium, one cannot rely on self-correcting forces. This prepares the ground for the insight that there are no simple recipes for solving the problem once and forever: developing the liberal order over time requires sticking to principles at the level of the higher order public good, but is not associated with a simple policy-guiding algorithm guaranteeing that one is always on the safe side. This implies intricate challenges – and reasonable pluralism and versatility within liberalism.

I now introduce the conceptual apparatus for making the relevant points in a more general way. This apparatus is borrowed from public goods theory, but with two major adaptations: (i) stressing the context- and mental model-dependent ("subjective") character of pertinent properties of goods and (ii) dissociating it from the kind of traditional market failure theory where public goods (as a special case of externalities) are just one case justifying the intervention of government. "Public goods" are *not* introduced in order to suggest that "government" is (or ought to be) an exogenous agent ready to rush whenever the market fails, "like the U.S. cavalry in a good Western," as Bob Sugden (2004, 3) ironically put it.<sup>9</sup> In keeping with Richard Wagner (2018) and rich traditions summarized in Sturn (2020a), I stress the fact that the state is not an exogenous agent, and that governance is inevitably entangled. However, this does not imply that the pivotal role of the private-public divide vanishes for a modern liberal order. On the contrary, stressing the fact that some background conditions supporting exchange may be brought about either as public goods by public gov-

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<sup>9</sup> Exogenous government was assumed by large parts of mainstream economics and still influences the rhetoric and probably the thinking of many, despite a fast-growing literature on rent-seeking and influence activities. In an economy with pervasive potentials for rents, governance using "the science of the legislator" in a circumspect and balanced way (à la Smith's TMS VI.2.ii.) will not operate on the working hypothesis that it implements improvements independent of influences from society and private economy. Government as a detached agency is less implausible when one heroically assumes a market economy approximately corresponding to some competitive ideal along Walrasian lines, where rents and externalities are not widespread, along with well-functioning competitive politics and a competent bureaucracy guided by professional ethos. The failure to address the discrepancy between this view and reality may play some role in crises of the liberal order.

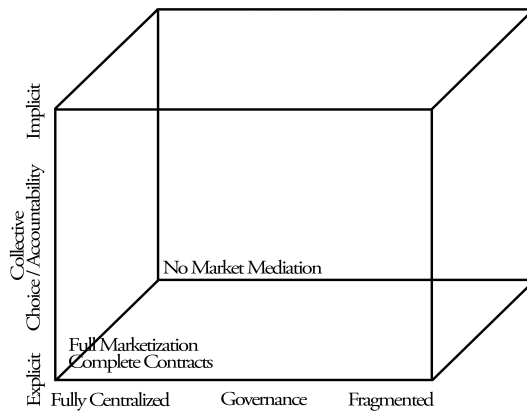


Figure 1: Public goods, private goods and mixed goods

ernance or by private or semi-private substitutes rather allows for a sharper analysis of the question: When is the higher order public good in jeopardy? This motivates an analytical framework allowing for a more rigorous demarcation of private and public sectors under changing circumstances.

In the context of stability problems of the liberal order, public goods theory is relevant for (i) identifying a class of technologically compound choices and (ii) as a framework for discussing problems and potentials of the substitutability (and complementarity) of (semi-)public and (semi-)private goods. Recall the definition of pure public goods by (1) non-excludability and (2) non-rivalry. While pure private goods are polar opposites of pure public goods, a range of mixed goods can be located in a corresponding two-dimensional coordinate system (Figure 1). The two criteria do not presuppose specific institutions. In particular, “public goods” neither presuppose a public sector that actually provides “public goods” nor a market that “fails.”

Public goods are commonly considered the functional core of the state. However, I here consider public goods as an element of a complex architecture:

- The liberal order is a higher-order public good. As it promotes the “freedom of the moderns,” openness, non-discrimination and the rule of law (conceptually associated with non-rivalry and non-excludability), it is *irreducibly* public: it cannot be substituted by (semi-)private goods relying on exclusion mechanisms. It is a complex good that is not provided by an agency aggregating and technologically transforming individual contributions: it is associated with the development of a coherent set of public rules and impartial enforcement procedures/mechanisms with weakest link properties – the core of a truly *public* sector.
- A liberal order typically requires publicly accountable provision of certain core first-order public goods such as security.

- Technically, first-order public goods may be privately provided. While in some cases this will be fine, in other cases under-provision may ensue, putting the liberal order at risk.
- Technically, first-order public goods may be substituted by private or semi-private goods. This may either be fine or deeply problematic: Some kinds of “security” may be provided by types of (semi-)private governance *incompatible* with the maintenance of the higher-order public good.
- The typology of goods may depend on people’s “subjective” mental models.

Let me expand on a few related aspects. First, as elaborated by Menger (1871) for goods in general, the facts underlying some public good may be unknown. The control of an epidemic is not perceived as a public good if its epidemiological characteristics or effective collective countermeasures are unknown. Climate policy is not regarded as the provision of a public good if people consider the corresponding cause–effect relationships cheap talk. In other cases, public goods might be out of sight due to practical irrelevance. Thus, in a consolidated system of private “protection agencies” (where everyone is accustomed to calling her private protector when criminal adversity threatens) the notion of security as a core first-order public good may be absent.

Second, as suggested by Knut Wicksell (1896), the concept of public goods allows for a rigorously individualistic model of state functions. Figure 1 provides a two-dimensional map that serves as a rough orientation for the kind of non-market governance that makes sense in given empirical circumstances (state, voluntary associations, “commons”; e.g. Buchanan and Tullock 1962). Over and above that, the Wicksellian program allows for analysis of potentials and drawbacks of electoral procedures and other mechanisms dealing with technologically compound choices unavoidably implied by non-rivalry. Wicksell introduces his quasi-unanimity rule with preference-sensitive individualized tax prices as a demonstration of the vast potential of collective choice consistent with individualist accountability.

Third, recall the properties of the liberal order as an artificial pure public good of higher order. It is the result of a co-evolutionary history of institutions, norms, and mental models (Denzau and North 1994), associated with a specific differentiation of private and public spheres. It *hinges* (i. e., it evolved on the basis of and now depends) on the non-discriminatory provision of core first-order public goods such as security and stability of possession, required for the kind of modern freedom and openness congruent with a capitalist market economy. And it is subject to destabilization by rent-grabbing and problematic private substitutes of core public goods. While there are no (semi-)private substitutes for the liberal order, there is a range of historical alternatives made available by the technological feasibility of (semi-)private substitutes of various first-order public goods. Governance implies non-market institutions (either formal or informal), but it need not be public governance. The provision of a certain degree of security and a certain kind of stability may, for example, be a product of semi-private governance of the East India Company as discussed by Adam Smith, or of feudal governance primarily aiming at securing feudal

power relations. Hence the usual microeconomic argument that private provision leads to an inefficient Nash equilibrium is subordinate in cases of *core first-order public goods*: in the view of the requirements of a liberal order, private provision primarily leads to *qualitatively different private substitutes*. While for mainstream economists the economic viability of private substitutes (expanding the sphere of technologically separable choices at the expense of technologically compound choices) might always sound like good news, the liberal order (the higher order public good) may not be well-served by proliferation of private substitutes. The latter rather might play an active part in undermining the liberal order by attenuating the private-public divide and compromising openness. Thus the specific requirements of liberal orders offer guidance for the appropriate scope of public sector activity, which in both directions may deviate from mechanical conclusions suggested by public goods theory.<sup>10</sup>

Fourth, consider the role of spontaneously emerging informal norms and institutions: since the time of “silent trade,” they had exchange-supporting functions when contract governance by formal institutions was inexistent or insufficient. However, far from being only of historical interest, they are crucially relevant for understanding modern institutional developments and their challenges: contract incompleteness makes it likely that they play a major role. Nonetheless, the emergence of the market economy from early modern times to the classical liberal capitalism of the 19<sup>th</sup> century is inconceivable without institutional change strengthening the public character of non-market governance: the *coordinating potential of markets* could be more fully exhausted and expanded due to (1) some degree of *centralization of governance* (superseding more parochial exchange-supporting mechanisms) and (2) transforming governance into an explicitly public affair, including specifically suitable forms of public accountability in politics and firms, entailing feedback mechanisms and some minimal individualist principles of collective choice constitutive of a public forum (“everybody should have a say in what importantly affects her,” non-dictatorship, non-imposition). While “active and constant participation in collective power” is no useful ideal under modern conditions of great societies, the more modest regulative idea of a public forum as a distortion-reducing filter of political accountability is an indispensable ingredient of a liberal order. Locating modern statehood within the more general coordinates of non-market institutions and mechanisms and

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<sup>10</sup> Kallhoff 2014. They may include activities *beyond* the provision of 1<sup>st</sup> order public goods. Both referees for this journal argue that limiting the functions of the public sector to provision of 1<sup>st</sup> order public goods may be wrong, as this fails to capture various functions of “protective state, productive state, redistributive state and regulating state” (ref. 1) or public provision of private goods such as education or museums (ref. 2). I agree. Depending on the nature of challenges, the evolution of mental models, and the workability of accountability mechanisms in the public sector, the scope of order-maintaining public sector activities may be wider, including some of the suggested functions. As stressed by Isaiah Berlin, the viability of a liberal order often was enhanced by a system of public education. On the other hand, in some cases private provision of pure public goods or private substitutes may be fine.



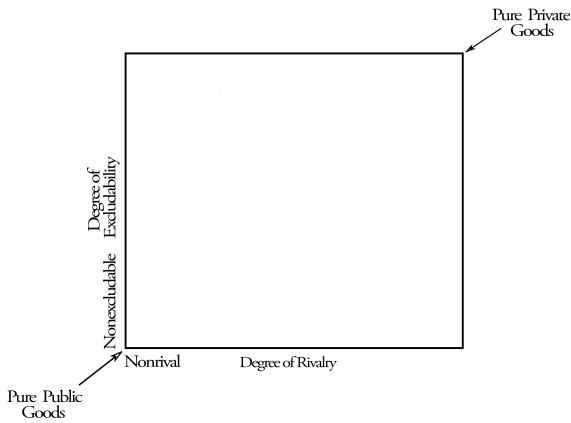


Figure 2: Governance cube: 100% realization of all three potentials is represented by the front–bottom–left–hand corner (the Benthamite ideal of rationalist modernization)

the development of the modern private sector thus can be shown by a three-dimensional coordinate system (Figure 2).

- (1) Potential of market mediation (technologically separable choices mediated by voluntary exchanges/contracts).
- (2) Potential of public governance accountability/explicit collective choice mediating technologically compound choices, including mechanisms of information, control, feedback, and individual participation.
- (3) Potential of governance centralization (geographic/social scope of technologically compound choices).

This invites several conjectures and thought experiments:

1. All combinations are logically possible, but some of them will be factually impossible (hinging on empirical assumptions about behavior and technologies incongruent with reality), some will be unstable, and/or incompatible with the current levels of division of labor, welfare, and population size (including the back-top-right-hand corner and the entire plane in the back where there is zero market mediation).
2. In terms of the development of the liberal order and socio-economic welfare, there are better and worse regions. Demonstrating the enhancement of liberty, creativity, entrepreneurship, and productivity associated with *individualization of choice* in a vast and expanding range of separable choices is one of the consistent achievements of otherwise diverse strands of liberal thought. The same holds for drawbacks of overcentralized collective choice mechanisms: centralized allocation of

private goods irrespective of individual needs and wants is associated with economics of shortage, the emergence of black markets and shadow economies.

3. In view of socio-economic dynamism, the location of favorable regions may change over time within the limits given by the basic principles of a liberal order. Liberal reform agenda are subject to trade-offs or changes in priorities.
4. Starting from combinations of thin markets, fragmented governance and weak mechanisms of public accountability, using the potentials along all three coordinates more fully has been important for the socio-economic dynamism of capitalism: modernization is represented by an arrow with the direction forward-bottom-left.
5. Moving to one of the corners of the cube is deeply problematic. This includes kinds of modernization aiming at fully exhausting one or more of the three potentials. For similar reasons, the challenges of political economy do not allow for defining a safe side; that is, there is no *a priori* unproblematic direction of change. There may be too much as well as too little governance centralization, explicit collective choice, and market mediation. The appropriate scale of governance may change under new regulatory challenges of the digital economy. The traditional architecture of nation states may become problematic as an institutional basis for a liberal order.

Why is fully exhausting all three potentials (front-bottom-left-hand corner) a problematic project? Approaching the limit of some potential implies that the drawbacks of pertinent mechanisms become more and more severe and difficult to cure: (1) The risks of governance centralization in view of diversity, fragmentation of knowledge, informational decentralization and power entrenchment are well understood by liberal thought. (2) Regarding explicit governance with public accountability, it may suffice to point to the problems and paradoxes of explicit collective choice analyzed by Social Choice theory. Not least due to the drawbacks of explicit collective choice mechanisms required for reasonable governance reform, some exchange-supporting informal institutions/norms may remain important. (3) Pushing the market to its limits (involving more and more complex transactions) is not only associated with increasing transaction costs à la Coase and Williamson (2000). It is also subject to the risk of exacerbating “political” problems of contract incompleteness, information asymmetries and widespread externalities increasingly difficult to combat, up to the point where they become so overwhelming that they render progress regarding Constant’s freedom of the modern spurious.

What may go wrong today? Consider the exchange-enhancing potential of the globalized digital economy, where transactions are facilitated by blockchains and smart contracts. This may go along with too much implicit collective choice, too little accountability, and too much proliferation of private substitutes of core public goods. Considering the development of rules of the game in the information/data economy, network technologies may co-evolve with an oligarchy of rule-makers imposing their choices on norm-takers in combination with distributional implications benefitting the

rule-makers, triggering a Medici vicious circle. Certain modes of deregulation and privatization may lead to centralization without political accountability (shadow politics). Some agents may be put into a privileged position, giving them potential for affecting the background conditions and the value of the alternatives of private choices of other agents.<sup>11</sup>

Assessing trade-offs, priorities, and risks in the evolution of governance is often impeded by the ambivalence of the common terms “market failure” and “government failure.” The former includes both (1) problems where the market is hardly a solution in the first place and (2) problems where it is a solution under appropriate rules, yet which fail to be implemented. Similarly, in the case of “policy failure,” it makes sense to differentiate between cases where privatization is or can be the solution and those where it certainly creates new problems or is a symptom of a Medici vicious circle. In this sense, four cases should be distinguished: *At level 1*, cases are considered in which the market (or the public sector) can be trusted in principle, but is subject to curable malfunctioning, which is why reforms should be directed towards implementing suitable rules and mechanisms. *Level 2* includes (i) dysfunctional collectivization of separable choices and (ii) problematic private substitutes for core first-order public goods. The second level is involved when the working of governance institutions goes along with a high number of veto players regarding private entrepreneurial decisions such that innovation is blocked, entrepreneurial energy stifled or pushed into the *shadow economy*. It is also involved when private provision rules the roost regarding technologically compound choices of rules, standards, and core first-order public goods. This is not market failure, but rather *shadow politics*: the predominance of private-sector logic in an area where the liberal order would require publicly accountable collective choice. Thus, the second level is related to pathological cases of mutual interpenetration between the private and public sectors – whereas the first level addresses subsystems failing in their very own functional areas.

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<sup>11</sup> Minimal government as a panacea implies steering clear of these complexities and contingencies. It is motivated by the conjecture that all the swamps of potential rent-seeking are drained if government spending is kept to a minimum. To be sure, a liberal order implies that government is kept within limits. Those limits are defined by the requirement of precluding fatal interpenetration of public and private. However, these limits are sustainable if and only if the state is responsive to newly emerging rent-potentials triggered by socio-economic dynamism. Hence slogans of a minimal state (which practically would isolate the state agency from this dynamism) provide no better guidance in neutralizing distortive influence activities than postulating exogenous government agency. Concepts giving the state a merely residual role are inadequate for coping with pertinent challenges. Denouncing the state as a necessary evil is inimical to the development of guiding principles counteracting forms of interpenetration such as the “Medici vicious circle.”

## 5. Protectionist Populism and Crises of the Liberal Order

Insofar populist anti-elitism and anti-pluralism has a basis in political economy (apart from political psychology), this is most likely associated with architectonic problems of the liberal order (level 2 failures). Pertinent issues indeed loom large in populist rhetoric, (i) denouncing a political caste imposing awful regulations constraining private choices in the name of political correctness, and (ii) taking issue with the alleged substitution of explicit collective choices (e.g. regarding globalization-related phenomena such as migration) either by market processes producing undesired macro results behind everyone's back or by elite conspirators who are never called to account: ironically, modern populism thus operates in the "shadow of accountability" (paraphrasing Müller's (2016) formula invoking representative democracy, a specific mechanism of accountability).

Populist strategies in the shadow of accountability are further benefitting from "progressive" mental models exaggerating the power and perfectibility of public accountability mechanisms. Nonetheless, identifying real accountability failures is a crucial priority, including cases where (a) the liberal order is being undermined by unintended consequences of socio-economic dynamism, or worse than that, where (b) those tendencies are promoted by visible hands operating in the twilight: shadow politics by an unaccountable oligarchy of norm-makers. Both of these tendencies have the systematic potential to provoke the kind of populist reactions conducive to social protectionism compromising openness.

Populist policy mixes are not designed for fixing the architectonic problems of modern institutions, not least because virulent architectonic problems provide fuel for populism. However, successful populists are versatile in navigating the governance cube, strategically employing the shadow of accountability. But irrespective of this versatility, the main thrust of populist recipes is to weaken the potential of public accountability mechanisms, either by hostility towards the cumbersome evolution of supra-national public spheres required for sustaining the liberal order in the digital transformation, or by directly promoting illiberal forms of shadow politics. While populist changes in governance will not bring us closer to a stable region, this benefits populist strategies up to the point where discrepancies with functional requirements become too big. Today, pertinent problems are exacerbated by the increasing scope and depth of global interdependencies, including the climate problem and widespread externalities occasioned by digital transformation.

All this leads to questions regarding the crises of liberalism as a political force. Viewing achievements and failures of political liberalism in retrospective, liberals were in trouble for two kinds of reasons: (1) adverse cultural trends and difficulties due to the logic of the political system, including strategies of political competitors, political psychology, and weakening of liberal civic spirit as the achievements of the liberal order were taken for granted. (2) Shortcomings of liberalism in responding to

current politico-economic challenges as discussed in the CWL. In that respect, liberalism navigates between Scylla of sticking to socio-economically contingent prioritizations that have become obsolete under changing challenges and the Charybdis of overshooting adaptation compromising foundational principles. These dangers again become politically virulent. The populist challenge inevitably triggers the search for new strategic combinations. Ill-considered combinations occasioned by superficial convergences may contribute to deepening the crisis of the liberal order.

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