

# **Capitalist transformation without political participation – German capitalism in the first half of the 19<sup>th</sup> century**

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The paper analyzes the political economy of capitalist transformation in 19<sup>th</sup> Germany. The emergence of capitalism after 1806 gives an example that economic freedom can precede political freedom, leaving the political power of the “dominant coalition” intact. The paper argues that the German capitalist transformation was instigated by competition among the European states. Primarily it was conducive to the monopolization of the coercive power of the state. As a result competition among the states drove a wedge between the interests of the monarch and his supporting dominant coalition (landed gentry). The increasingly independent public administration in Prussia which was influenced by Adam Smith’s liberal ideas organized a political bargain which established economic freedom in various sectors but took the economic interests of the landed gentry into account. In various aspects the sweeping institutional change was Pareto-superior for groups, which made capitalism also acceptable for the elite group. Keywords: Industrialization, Capitalist Institutions, Economic Freedom, Political Order (JEL-Classification: N4, O14, P1);

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## I. Introduction

The analysis of transformation processes towards modern capitalism is a challenge for institutional economics. North/Wallis/Weingast (2009) offer a concise theoretical framework which encompasses economics, history and political science. They analyze historical transformation processes of advanced capitalist economies but also of current transition economies in Latin America, Africa or elsewhere (North/Wallis/Webb/Weingast, 2012). A cornerstone in their analysis is the rejection of the idea that economic and political institutions are independent from each other. Unlike sociologists or economists who argue that capitalist institutions might be compatible with a variety of political orders ranging from democracy on the one hand to dictatorship to the other, North/Wallis/Weingast (henceforth NWW) stress the interdependence between political and economic orders: in order to be sustainable, a competitive (open access) economic order needs to rest upon democracy, which implies that competition is the ruling principle in both spheres.<sup>3</sup> Specifically, the theoretical framework relies on the requirements of capitalist dynamics and the capacity of innovation. As NWW put it: "...creative destruction reigns in open access politics just as it does in open access economies" (ibid., 24). Thereby, the authors introduce the idea of a double balance between the political and the economic order: "open access and entry to organizations in the economy support open access in politics, and open access and entry in politics support open access in the economy." (ibid.). The key effect of that double balance is that "the economy generates a large and varied set of organizations that are the primary agents in the process of creative destruction" (ibid.). As NWW convincingly argue, the presence of a civil society and political participation prevents elite groups from using their political power to safeguard themselves from creative destruction. If political power is only temporarily given and exposed to competition, it cannot be used for long term rent creation. Although rent *seeking* is a ubiquitous feature of any political order, limited access orders (LAO) hinge on rent *creation* and thus constrain or impede

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<sup>3</sup> ) Compare Streeck (2013) for a renewed argument that democracy is at variance with capitalism. Schumpeter (1987) supports the idea that political and economic orders are independent from each other, which is strongly rejected by Eucken (2004, 182).

capitalist dynamics. Rent seeking means that a group influences an independent legislation in order to pursue its self-interests; by contrast in LAO, the group itself is the legislator that controls any relevant economic activities within its territory. Restriction of market access becomes a regular part of politics. It keeps competition in check, either by protecting its own economic activities or by leasing market access rights to economic agents in exchange for political support. Capitalist dynamics are stifled. By contrast, only open access in politics which does not discriminate for or against certain groups in legislation prevents rent creation *by means of authority* and sets the stage for a competitive economic order. Thus, open access in politics dovetails with open access in the economy. NWW discuss Britain, France and the United States as an example for the double balance of democracy and capitalism.

Acemoglu/Johnson (2012) employ a similar theory which likewise stresses the requirement of political rights and economic freedom. Even though their terminology differs from NWW, their key argument is quite analogous: only the removal of political privileges from an elite group can instigate creative destruction in the economy. Several examples in economic history are given which point to the fact that elite groups in non-democratic societies stick to limited market access in order to avoid the creative destruction of their own economic activities. Thereby, they view the elite group as the natural advocate of a traditional (limited access) economic and political order while the rest of society is likely to have a genuine interest in capitalist institutions. Historically, for example, industrial capitalism was allegedly beyond the interest of a traditional elite group of land owners.

“European history provides a vivid example of the consequences of creative destruction. On the eve of the Industrial Revolution in the eighteenth century, the governments of most European countries were controlled by aristocracies and traditional elites, whose major source of income was from landholdings granted and entry barriers imposed by monarchs. Consistent with the idea of creative destruction, the spread of industries ... took resources away from the land, reduced land rents and increased the wages that landowners had to pay their workers. These elites also saw the emergence of new businessmen and merchants eroding their trading privileges. All in all, they were the clear economic losers from industrialization” (Acemoglu/Johnson, 2012, 85).

Even though this sounds very plausible, it leads to a misinterpretation of the emergence of capitalism in Central Europe, as I intend to demonstrate below. As a result, Acemoglu/Johnson (2012) presume antagonist interests between the traditional elite group and the (judicially and economically) underprivileged rest of society. In line with this explanatory scheme, Acemoglu et al. (2011) argue that capitalism in Germany, at least in the fast developing Rhine region, must have been the result of “imposed” capitalist institutions which purportedly overturned the

economic interests of the elite group.<sup>4</sup> Unlike Acemoglu/Johnson (2012) and Acemoglu et al. (2011), NWW emphasize that any successful capitalist transformation process has to meet the economic interests of the dominant coalition as well; as long as a sizeable new class of capitalists has not come into being, the interests of the elite group cannot be compromised. From NWW's point of view it is the dominant coalition itself rather than the underprivileged part of society which requires to set the transformation process towards capitalism in motion – despite the fact that it will ultimately become deprived of its political and, most likely, also its economic privileges.

This seems to be a more sensible view since it takes the power relationships in society as a matter of fact and analyzes the requirements of endogenous transformation. To most countries, gradual transformation seems to be the only feasible option. The dominant coalition, or parts of it, plays an active role in the transformation process rather than being the object supplanted by a revolution. The post-revolutionary period in France, for instance, demonstrates that in the absence of a prosperous entrepreneurial and middle class, a revolution was unable to assure its achievements in the long term.<sup>5</sup> In the following, I shall use NWW's approach as the point of departure for the analysis of capitalist transformation in Germany.

NWW concentrate on the emergence of capitalism in France, the UK and in the US. Besides occasional remarks, they disregard the German case. This is striking since German society and economy underwent a fundamental transformation towards capitalism in the span of few decades in the 19<sup>th</sup> century. The absence of a revolutionary incidence comparable to the Glorious Revolution or the French Revolution has detracted the interest of institutional economists from gradual but nevertheless sweeping institutional changes. While in the end of the 18<sup>th</sup> century more than three hundred independent German territories and cities were lagging far behind the British pioneers of capitalism, the German states soon transformed their institutions to become one of the great European centers of capitalism and industrialization in the second half of the 19<sup>th</sup> century. The main institutional changes were undertaken before the unification in 1871 and have to be analyzed distinctively.

It is misleading to look for an institutional “big bang”, as proposed by Acemoglu et al. (2011) with respect to institutional change in Germany in the 19<sup>th</sup> century. In their view, institutional change was not *chosen* but *imposed* by the French occupation of the Rhenish

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<sup>4</sup> ) For a detailed critique of Acemoglu et al. (2011) see Reckendrees/Wegner (2014)

<sup>5</sup> ) For an analysis of the post-revolutionary restoration period in France which has brought about a new elite group formed by the nobility and the land-owning bourgeoisie (“notables”) see Haupt (2006, 1989). After the revolutionary shock, the nobility managed to retain much of the confiscated land, while Napoleon's legislation constrained the recently attained freedom movement of the workers by re-establishing the so-called working book (“livret”) in 1803; coalitions for workers remained forbidden until 1864; see Haupt (1989, 37 and 43).

territories from 1795 to 1815 (*ibid.* 3287, italics in the original); namely the imposition of the French civil code and the forced replacement of the nobility had a long-lasting effect on the economic development, while neither the rule of law nor the security of property rights were present in the rest of Germany (*ibid.*). This is a misleading and inaccurate interpretation.<sup>6</sup> Acemoglu et al.'s "big bang"-explanation not only neglects the institutional change in the late 18<sup>th</sup> century, in particular the erosion of the late-absolutist, restrictive economic institutions, but also ignores the fact that after the French occupation in 1815 bureaucratic elite in Prussia obtained the power to remove the imposed institutional changes in Rhenish territories, but never did so. Instead, further institutional reforms toward capitalism were continued and intensified without any external imposition. These reforms prepared the ground for capitalist development. The deep institutional change in the first decades of the 19<sup>th</sup> century is easily overlooked because political participation was absent for a long time. The fact that only economic institutions underwent fundamental changes cannot be brought in accordance with Acemoglu/Robinson's (2012) and Acemoglu et al.'s (2011) view.

NWW's approach is better suited as an explanation but also needs adaptation. Supportive to NWW's explanatory scheme is the fact that the institutional transformation was accompanied by a process of state-building and the monopolization of coercive power of the state, as we will show below. However, the implementation of economic institutions constitutive for capitalism did not come along with open access in politics as predicted by the theory. Namely in Prussia a constitution which set limits to the power of the monarch was absent until 1848. But this did not obstruct the promotion of capitalist institutions. Instead, Prussia advanced liberal economic policy in many fields, as indicated by the absence of corporate taxes and the avoidance of tariff barriers for industry before 1850. Remarkably, economic policy in Britain and the US at the same time protected domestic industries with high tariffs.<sup>7</sup> While institutional reforms prepared the grounds for capitalist development in Prussia, Southern German states such as Bavaria introduced constitutions and formally guaranteed civil rights but supported traditional economic institutions such as guilds for more decades (until 1848). These developments call into question NWW's idea of a double balance between economic and political institutions and require theoretical modification.<sup>8</sup>

In the following, I intend to check the general claim of NWW's approach in light of the German case of capitalist transformation. Obviously, that specific case demonstrates the

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<sup>6</sup> ) See Congleton (2007) who supports the view that constitutional change in Germany resulted from constitutional compromises "rather than imposed by victorious armies" (*ibid.* 483 – 484).

<sup>7</sup> ) See Dedinger (2006, 231) and Grimmer-Solem (2014)

<sup>8</sup> ) See also Zweynert (2011)

possibility of a concomitance of industrial development without democracy for a longer period. One potential way to remedy NWW's approach is to dispute that the political order in 19<sup>th</sup> century Germany was as closed (that is autocratic) as it is commonly assumed. Indeed, with respect to the Kaiserreich doubts as to the closeness of the political system are warranted; for instance, even though the political order was not a democracy in the modern sense, it was impossible to pass laws without the approval of the Reichstag which also possessed qualified rights of legislative initiative and budgetary rights. Since it was elected by universal manhood suffrage - an unusually democratic franchise for the time - the political order was a hybrid system which combined elements of a monarchy and a representative democracy.<sup>9</sup>

However, such a re-interpretation does not hold with respect to the first decades of the 19<sup>th</sup> century. I therefore concentrate on this period. The question to be addressed is whether an adapted institutional theory expands on our understanding of the constitutive conditions of transformation societies beyond the German case. I isolate three major factors that are highly relevant for the emergence of capitalism without political participation in 19<sup>th</sup> century Germany: a) competition among the states; (b) the emergence of a semi-independent bureaucracy operating according to formal rules; and (c) the sufficient separation of economic interests between the dominant coalition and the new class of capitalists, which constrained the negative effect of rent creation by the dominant coalition. In order to limit the scope of the paper, I mention another supportive factors only in passing: The ideals of the age of enlightenment, philosophically represented in Kant's and Rousseau's philosophy, asserted formally by the Declaration of Rights of Man and the Citizen of the French National Assembly and set into practice by the new American republic, formed a cultural climate that set German aristocratic power holders under ideological pressure by the nascent public discourse. Notwithstanding the distribution of political power, elite groups could not ignore these new criteria of legitimacy in their practical policies. In combination with other factors, the great transformation towards capitalism became possible in the German states.

The subsequent argument will proceed as follows. First, I characterize the changing political and economic order of early 19<sup>th</sup> century Germany from the viewpoint of NWW's theoretical framework of institutional economics. Then, I depict how this societal order interfered with the requirements of capitalist society, which made an institutional revolution

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<sup>9</sup> ) Since only men aged 25 or older had the right to vote, the fast growing and younger working class was underrepresented in the parliament but nevertheless provided a strong faction in the Reichstag after 1890; in 1912 the SPD (German Social Democratic Party) became the largest faction. In the decades after 1871, the voter turnout rose to more than 80 percent and a political public discourse which is an element of vivid democracy was present as in other Western democracies. It is therefore a misperception if the Kaiserreich is proclaimed as a perfect example of an authoritarian political order; for a re-assessing see Grimmer-Solem (2014) and Kroll (2013).

necessary; I describe its ambitions and its realization by focusing on the political economy of far reaching institutional change. Finally, I highlight those conditions conducive to capitalism which seem to be of general relevance. I also point to the deficiencies of the economic development in Germany caused by a lack of political participation.

## **II. The Economic Order of Late Absolutism**

The economic order in Germany before the French Revolution defies a straightforward description because distinct societal orders coexisted in different regions<sup>10</sup>. Split into more than 300 territories (of which some were tiny and hardly bigger than counties) and more than 1000 politically independent manors, a coherent state did not exist. Nor had the state established the monopoly of coercive power in the sense of Max Weber. In contrast to absolutist France where political power shifted to the monarch in the late 17<sup>th</sup> century, the centralization of the power of the state was less pronounced; South German states such as Württemberg and Bavaria were exceptional cases of enlightened absolutism. In Prussia, the largest German state, the distribution of power within the dominant coalition remained more balanced on behalf of the Junker landlords. Here, the feuds of the aristocracy had been transformed into private property after the so-called allodification in the early 18<sup>th</sup> century and thus counterbalanced the power of the monarch. Particularly in the Eastern parts of Germany (with the Elbe River framing the border), the land-owning nobility formed an integral part of the state. Due to a lack of public administration, the lords of the manors held key functions of the state such as police and patrimonial jurisdiction. The mass of peasants was subject to their rule. If peasants owned land at all, their property degenerated into a revocable right of use. Hence, the lords were land owners, employers, policemen and judges at the same time<sup>11</sup>. Likewise, the decentralization of coercive power of the state implied a lack of separation of powers. Particularly in the late absolutist period after the allodification the aristocracy could avail itself of its privileged status by accumulating land at the expense of peasants (“Bauernlegen”) and by exploiting them. For instance, the land-owning nobility could determine the amount of tributes and the extent of compulsory labor of their manorial subjects without any formal regulations.<sup>12</sup> Their own patriarchal duties were limited and, above all, not enforceable by their subjects. Hence, the extent of exploitation of the peasants was only constrained by the self-interest of the lords in order to keep them capable of work. Furthermore, manorial subjects were bound to the land and

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<sup>10</sup> For the historical description, see Wehler (2008, Vol. I).

<sup>11</sup> )See Gray (1986, 16).

<sup>12</sup> ) Inherited manorial subordination must not be mixed up with serfdom in the Middle Ages.

were deprived of the freedom of movement. For this reason, an all-inclusive capitalist labor market could not come into being.

This feudal order largely determined social relationships in the rural area in the East of the river Elbe but did not encompass the other German territories, as Acemoglu/Robinson's misleading map of serfdom in Europe suggests (Acemoglu/Robinson, 2012, 107). In the Western parts, namely the region close to the Rhine River, serfdom did not exist or ceased to exist in practice. Instead, peasants had to pay rents to the land-owning nobility but were not subject to its personal rule.<sup>13</sup> The political power of the aristocracy decreased and fell far behind that of the nobility of the East-Elbian regions. In addition, towns contributed to the diminished power of the nobility in the Rhenish region (see below). When Napoleon abolished serfdom in the newly created Kingdom of Westphalia in 1808, this enactment was only a formal act in accordance with the extant "informal institutions" (North, 1990, ch. 5), that is, there had been a de facto erosion of serfdom prior, rather than a radical topdown reform as claimed by Acemoglu et al. (2011). In many other West-Elbian regions of Germany serfdom was abolished during the 18<sup>th</sup> century, for instance in Baden, Bavaria, Brunswick and parts of Holstein.

Cities and towns, above all the sovereign cities of Hamburg, Bremen, Lübeck, Augsburg or Frankfurt, exhibited completely different economic and political orders without serfdom. Here, an independent citizenry held authority. Merchants, tradesmen and craftsmen were organized in guilds and created rents through cartels (or cartel like agreements) and the control of market entry. Unlike modern cartels, guilds were authorized to sanction infringements of their rules.<sup>14</sup> While cities offered freedom for their inhabitants, the rights to join them were restricted in order to protect the rents of the guilds (in some cases, e.g. in Hamburg, until 1860). Monarchs and dukes largely accepted the independence of the citizenry and likewise the restrictions in the freedom of movement. Nevertheless, even this medieval order came under pressure and eroded when the growing population began to search for new income opportunities.<sup>15</sup> Under this pressure it became increasingly difficult for the incumbent guilds to protect their markets. The erosion of the guilds took place in the 18<sup>th</sup> century before the French

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<sup>13</sup> ) According to Wehler (2008) the variety of social conditions was one of the reasons why a French Revolution did not occur in Germany; since dependency differed largely across regions ranging from serfdom in the East to rather mild impersonal rent duties in the West and South, peasants did not form a coherent and solidly united class.

<sup>14</sup> ) Guilds had also a political dimension because it were the guilds through which the citizens participated in governing the cities in medieval towns.

<sup>15</sup> ) See Gray (1986, 24). The guilds system of the late 18<sup>th</sup> century apparently was more flexible than usually considered. In Saxony it was formally abolished rather late (in 1848) but formed the basis for a new industry that successfully integrated into the market, which is why Saxony became a center of industrial development based on consumer products.

Revolution, which puts Acemoglu et al.'s (2011) view of Napoleon's top down institutional revolution in the Rhenish territories into perspective.<sup>16</sup>

Furthermore, manufacturers increasingly lost their position as monopolists. While in the 17<sup>th</sup> century monarchs granted licenses to manufactories as privileges, they partly changed this practice in the 18<sup>th</sup> century. This is also reflected by a change in stance among political economists of that time regarding competition, as discovered in recent research. Seckendorff for instance considered the guilds an instrument for consumer protection and preferred competition for quality (Vollmer, 2012). Volckart (2012) shows that cameralistic political economists, who initially supported the restriction of trade, gradually revised their anti-competitive view throughout the 18<sup>th</sup> century and adopted a more pro-competition perspective, namely with respect to the cities.

As a result, the economic order in the late 18<sup>th</sup> century should not be considered as an unchanged, extended form of the medieval societal order. A practical result of its longer-term erosion is the gradual transformation of merchants formerly protected by medieval cartels; as it turned out within a few decades they developed into a new class of capitalists. Of course, these municipal merchants benefitted from their former civic privileges and entered the age of capitalism in many cases as wealthy citizens. Their privileges originated from the former economic order, which made dynamic capitalism acceptable for the elite group in the cities. If they had been on the losing side in the beginning of capitalism, e.g. as a result of a foreseeable "creative destruction", they could have obstructed capitalism quite easily by making use of their political power. The preservation of their economic status quo was indispensable for imminent far-reaching institutional change.

The Western part of Germany alongside the Rhine River, which became part of Prussia after the Vienna Congress in 1814-1815, exhibited a social and economic order that was more determined by the citizenry, while the feudal land owners played a diminishing and sometimes negligible role. This was one reason why the region emerged as a center of capitalist development in the later decades. For several reasons (e.g. some wars) this development was constrained up to the beginning of the 19<sup>th</sup> century, which is why it could not make use of its key comparative advantages, namely the proximity to markets in Western Europe (Belgium, the Netherlands and Britain).<sup>17</sup> One obstacle was the lack of centralized power of the state in the 18<sup>th</sup> century, which accords with NWW's institutional approach: Trade between the territories – and even within them – was impeded by tariffs that were the main source of

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<sup>16</sup> ) See Reckendrees (2010, 55)

<sup>17</sup> ) See also Wolf, N. (2008).

revenues for the sovereigns. Transportation on the Rhine River in particular was costly due to numerous tariffs, impediments and obligations. Major impediments were abolished in 1831; in 1868 the Rhine River became a free-trade route (Rheinschiffahrtsakte of Mainz and Mannheim, respectively). After this period the trade route of the Rhine River integrated the emerging transnational markets of Rhine-Prussia, Belgium, the Netherlands and England. Prior to then, the markets were fragmented. Hence, the transnational integration of the Rhenish territories (an important coal-mining region in the 19<sup>th</sup> century) was a key factor in unleashing capitalist dynamics.<sup>18</sup>

Territorial disintegration delayed capitalism in all German territories. In view of the hundreds of German states before 1804, the incentive for constructing new traffic routes was rather low because positive spill-over effects of interstate routes could not be internalized. This gave rise to a common good problem as to the construction of roads and canals. For bigger territories such as Prussia, the roads were kept in poor condition because of the military threat of invading armies; poor roads were a natural impediment for invading armies and intentionally taken into account. As a result, a common market in Germany did not exist and only gradually emerged in the first half of the 19<sup>th</sup> century. The absence of a common market, in turn, undermined incentives for the promotion of manufactories, even though some sovereigns – advised by cameralistic political economists – had some success with these.

Around 1800, a common labor market did not exist. Some cities (Hamburg, Frankfurt) still controlled the influx of the labor force in order to protect the guilds and to control obligatory donations for people in need. The serfdom of peasants (Gutsherrschaft) in Eastern parts of Prussia formally prevented the movement of workers to other territories or cities. However, a shortage of labor for new industrial sectors did not necessarily arise from this restriction. Population growth was sufficient to satisfy the demand for labor in other sectors, which is why a reduction of the labor force in the countryside in absolute terms was not required. This phenomenon parallels the feature of English capitalism in the 18<sup>th</sup> century (Deane, 1977).

### **III. The Institutional Revolution after 1815**

The multitude of German territories and their proximity to other surrounding countries which had become nation states created an environment that was marked by military and economic

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<sup>18</sup> ) Acemoglu et al. (2011) apparently are not aware of the crucial importance of the “Rheinschiffahrtsakte” which created a transnational capitalist market in Western Europe.

rivalry. This was unknown to large empires such as Russia or China. Jones (2012) identifies this rivalry as a crucial driver for the “European miracle”. Similarly, philosophers of that time viewed the competition among the states as an effective means to establish the key norms of enlightenment: civic freedom and the equality before the law. As Kant argued on the eve of French Revolution:

“At present, states are in such an artificial relation to each other that none of them can neglect its internal cultural development without losing power and influence among the others. Therefore the preservation of this natural end [culture], if not progress in it, is fairly well assured by the ambitions of states. Furthermore, civic freedom can hardly be infringed without the evil consequences being felt in all walks of life, especially in commerce, where the effect is loss of power of the state in its foreign relations. When the citizen is hindered in seeking his own welfare in his own way, so long as it is consistent with the freedom of others, the vitality of the entire enterprise is sapped, and therewith the powers of the whole are diminished. (Kant, *Ideas for a Universal History from a Cosmopolitan Point of View*, 1784.)

Kant’s argument parallels Adam Smith’s “invisible hand explanation” as he only demands rational monarchs to be in accordance with their own interests; enlightenment would then eventually become the unintended result of rational behavior of the principal:

“Enlightenment comes gradually, with intermittent folly and caprice, as a great good which must finally save men from the selfish aggrandizement of their masters, always assuming that the latter know their own interest.” (Kant, *ibid.*)

Competition between the states constrained the power of the monarchs in Central Europe. One practical result was the security of property rights.<sup>19</sup> The Prussian Common Law that was installed in 1794 (*Allgemeines Landrecht*) protected property rights by setting strong constraints upon the confiscation of property on behalf of the public interest; even in that case compensation was mandatory. Due to the distribution of power in the late absolutist order this restriction was a self-commitment of the sovereign which was sufficient to guarantee property rights in practice; arbitrary confiscation of property was unknown in the German states even before the establishment of constitutions. The authors of the Prussian Common Law intended to overcome privileges of the nobility and sought to treat all individuals as equal subjects; however, due to the late-absolutist order privileges for the nobility prevailed after the establishment of the Prussian Common Law.

The military defeat of the Prussian army by France at the battle of Jena and Auerstedt in 1806 instigated sweeping institutional changes. These legal changes were much in accordance with the intentions of the authors of the Prussian civic code a few years prior. Now,

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<sup>19</sup> For a general view on competition between the states see Bernholz/Vaubel (2007).

open minded ministers such as Hardenberg and Stein took initiative and drew far reaching consequences from the economic and political backwardness of the Prussian society, which was interpreted as a major cause for the defeat. These reformers were successful in convincing the monarchs of their proposals.<sup>20</sup>

The dissolution of the still existing Holy Empire in 1806 was highly supportive for their proposals. In the aftermath of this event, more than 300 independent territories were consolidated to 34 territories (and four independent cities). As a result of the Napoleonic occupation, the number of rulers sank, and numerous knights, dukes (Landesherren) and archbishops lost their sovereignty.<sup>21</sup> In turn, the coercive power of the states became more centralized than ever. Acemoglu et al. (2011) emphasize the fact that in the occupied regions the nobility lost its economic power as a result of occupation. However, their powers had already been eroded throughout the 18<sup>th</sup> century and were of minor importance before French rule. Of greater economic significance was the fact that the annexed regions on the left bank of the Rhine River attained access to the French market and, as a result, also to the Mediterranean markets via the harbor of Marseille. On the other hand, the occupied regions were cut off from the British market as a result of Napoleon's continental system; while some firms (such as in the textile sector) profited from this imposed protectionism for a while, the pressure from competition became much harder when the continental system was lifted after Napoleon's defeat.

From the viewpoint of NWW's approach, the coincidence of two developments instigated capitalism: the monopolization of coercive power of the state and key institutional reforms which opened access to markets. The gain in power of the ruling kings and dukes resulted from the consolidation and, as in the case of Prussia, the enlargement of their territories as well as from the decreasing significance of the nobility for the execution of state power. These processes proceeded differently in the states. For instance, the political influence of the nobility in Bavaria continued to decline after 1815 while this development was much slower in Prussia and only accelerated after 1848. At the same time, institutional reforms abolished major characteristics of the late-absolutist economic order.

To summarize, key steps towards economic freedom in Prussia after 1807 included the following:<sup>22</sup>

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<sup>20</sup> ) See the in-depth study of Koselleck (1989)

<sup>21</sup> ) Formally, they became subjects of the remaining sovereigns but retained a privileged legal and social status up to the 1848 revolution.

<sup>22</sup> See Wischermann/Nieberding (2004, 57 – 65)

- Guilds were dissolved and reduced to private associations without administrative functions; thereby the freedom to choose an occupation became established;
- Restrictions concerning the ownership of land were removed; now commoners could buy and bequeath land;
- Serfdom was formally dissolved even though the released workers in East Prussia, unlike Wuerttemberg, had to pay rents or hand over land in exchange of personal freedom and the transfer of land, the so-called “Ablösung” (redemption);
- Freedom of movement was guaranteed to all individuals including peasants;
- Marriages of peasants became possible without agreement of the lords of the manor (a measure which controlled birth rates up to that point);
- Jews were given the freedom to choose an occupation (with the exception of the public sector until 1848) and were relieved from extra taxes.

The motivation for the reforms came from the military defeat but nevertheless emerged internally in Prussia, a fact which is completely ignored by Acemoglu et al. (2011). Imposed contributions and the intention to fend off occupation made the necessity of societal and economic reforms obvious. Hence, open minded senior officials such as Hardenberg found support from the king for far-reaching reforms. (Koselleck, 1989, 169 – 171). As Koselleck puts it:

“Public administration in Prussia deliberately opted for Adam Smith against Napoleon in order to dispel the latter by means of the former. It took up the challenge of instigating an industrial revolution in order to avoid a French revolution but nonetheless realize its ambitions.”

(Koselleck, 1989, 14, my own translation)

The reforms abolished the late-absolutist economic order and paved the way towards capitalism. However, it is misleading to focus on the security of property rights, which plays a major role in the interpretation of institutional reforms towards capitalism according to Acemoglu et al. (2011), Acemoglu/Robinson (2012) and North/Weingast (1989). As a closer look shows, the Prussian reforms primarily aimed at the freedom of contract and individual freedom. The security of property rights, by contrast, was not an issue – for the simple reason that property rights were already established. The only exceptional case were mining rights which were only temporarily given to private firms and required a renewal (Reckendrees, 2010, 56). Arbitrary confiscation of property was unknown and illegitimate even under absolutism. In a certain sense the Prussian reforms respected traditional property rights even better than the

French Revolution since the land-owning nobility completely retained its land property.<sup>23</sup> When serfdom was formally abolished in 1807, workers had to pay fixed-term rents for landed property (Ablösung) or hand over land in exchange for the redemption of labor services; smaller farms were exempted from this obligation. Commons were privatized and appropriated by the nobility. Some years later, only in Württemberg peasants were freed without compensation by the noble land owners. The main reason for this was that the nobility played a less important role than in Prussia.

From an economic point of view, the institutional reforms can be interpreted as Pareto-superior because the status-quo distribution of wealth was retained; as a whole, the economic situation of all members of society improved, either in terms of economic freedom or in terms of resources, or both. By contrast, the French Revolution also changed the initial endowments in response to revolutionary claims in 1792, which transformed the society into land owners and brought about a new class of notables. This re-distribution of wealth was a more revolutionary act of institutional transformation.<sup>24</sup> Rather than forming the beginning of industrial capitalism, this measure impeded the development of an English-style industrial capitalism since land remained the key economic resource of the notables.<sup>25</sup>

With the resulting economic freedom, the Prussian reforms of 1807 and 1811 proved to be the major institutional changes that initiated the development of a capitalist order in “old” Prussia (that is Prussia without its Western provinces). Of key importance was the removal of the privileges of the nobility concerning land acquisition and serfdom, which established free markets for land and labor. However, the noble land owners did not become the economic losers of institutional change and the capitalist transformation process. Unlike Acemoglu/Johnson’s (2012) opinion about the typical course of industrialization, there was no creative destruction to the detriment of the nobility.<sup>26</sup> Nor was it a necessary condition for capitalism. In economic terms, the nobility was transformed into an agro-capitalist class. The enlargement of their landed property as a result of the abolishment of serfdom raised their sources of income. In correspondence to the growing population, the domestic (but also foreign) market for agricultural products expanded throughout the next decades, and the dominant coalition could thus deem the incipient industries and the agricultural sector to be complementary rather than

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<sup>23</sup> Since the political influence of the nobility was severely reduced by the French absolutist regime, no allodification took place which transformed feuds into property rights in France.

<sup>24</sup> ) Nevertheless, the nobility regained much of the confiscated land after the revolutionary period when Louis XVIII came into power (Haupt, 1989, 37).

<sup>25</sup> This is the famous verdict of Marx/Engels (1848); in contrast to this view, Haupt argues that the importance of land instigated a capitalist order based on small-sized firms which became the point of departure for modern capitalism in France.

<sup>26</sup> See Acemoglu/ Johnson (2012, 85) as quoted above.

at odds with each other. At the initial stage of industrial development labor demand in the industry was still low and unable to absorb the labor force from the agricultural sector. Hence, creative destruction was a scenario for the distant future and did not become manifest in the early decades of the 19<sup>th</sup> century. Labor was abundant and far from being a constraint to economic development. Therefore the removal of economic privileges, namely the removal of serfdom, had no straightforward impact on the income of noble land owners. Rather, the abundance of labor combined with the compensation for the removal of serfdom ensured that the nobility was on the winning side in economic terms, at least for the decades prior to the period of high industrialization that started in the late 1870s. Before then, the long-term demise of the nobility as an economic class was an unlikely scenario, which is why it could tolerate the sweeping institutional changes.

Hence, capitalism in Germany started within the extant *political* order. Despite the fact that the nobility lost its key economic privileges, it drew advantages from its political privileges (Borchardt, 1977, 150 – 153; Wehler, 2008, Vol. II, 151). For the following reasons a revolutionary transformation, namely the removal of the noble elite group, was not an option in Prussia: (1) In contrast to Britain, where capitalism started earlier and brought about a class of wealthy merchants represented by the Whigs in parliament, a similar class of bourgeois capitalists that could have been supportive of societal transformation did not exist at that time in Germany. The capitalist class was the conceivable *outcome* of capitalist transformation, but in this embryonic stage it was not able to play a role as the main driving force. This point of departure did not differ significantly from the French Revolution and probably generalizes to any capitalist transformation.<sup>27</sup> As a result, an economically powerful rival for the landed gentry did not exist in the Eastern part of Germany. (2) As a consequence of the French occupation, massive contributions were levied on the German states including Prussia. Since the financial sector was not developed, the state had to take out loans from the nobility.<sup>28</sup> After the victory of the alliance over Napoleon in the Battle of Waterloo, the Prussian state remained constantly insolvent and dependent on the financial assistance of the land-owning nobility. Thus, its removal as a dominant coalition was not a feasible political option. Instead, the principals (kings and dukes) had to find a compromise between the land-owning nobility and the requirements

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<sup>27</sup> ) This finding differs from Marx and Engels' (1848) interpretation of the French Revolution; according to their diagnosis, the new bourgeois class deposed of the nobility and prepared the ground for introducing capitalism. However, a capitalist bourgeoisie developed in France many decades later which paralleled the development in Germany. Besides, the motivating forces of the French Revolution also encompassed parts of the nobility (which opposed to the absolutist regime of Louis XVI), the lower part of the clergy, the peasants which radicalized in the second part of the French Revolution after 1792, and the city proletariat in Paris which was ready to use violence. Hence, the French Revolution can hardly be interpreted as the revolution of the bourgeoisie against the nobility.

<sup>28</sup> ) See Koselleck (1989, 167, 170).

of market-oriented reforms. In the end, national insolvency of the Prussian state was supportive to liberal reforms: the promotion of the economy gained top priority for all members of the dominant coalition, which is why reformers were able to launch major steps towards the establishment of economic freedom. Unlike reform-oriented members of the nobility such as Stein and Hardenberg, their conservative counterparts could not offer a feasible alternative and thus tolerated the reforms in the face of military challenge.

Soon after Napoleon's defeat, the reactionary part of the nobility in Austria and Prussia gained ground; the Austrian Chancellor Metternich and his conservative allies (such as v.d. Marwitz) fought liberal norms and attempted to restore the late-absolutist economic and political order. In spite of these efforts, which constrained political freedom and the freedom of opinion – known as the Metternich restoration period –, liberal reformers managed to secure the most important parts of their reforms launched in previous years. As a long-term by-product of the military challenge, the reforms drove a wedge between the self-interest of the monarch and the rest of the dominant coalition, namely the landed gentry which held key state functions up to the Napoleonic occupation. Now the power of the state became more concentrated. As a result, the reform-oriented bureaucracy gained independence and thus pursued economic reforms which strengthened the economic (but also military) capacity of the state. This reinforces NWW's argument that modern capitalism emerges in correspondence to the monopoly of coercive power of the state.

As a by-product of independence, the reform-oriented public administration convinced the Prussian king to keep the French civic code in some parts of Rhenish Prussia, mainly on the left bank of the Rhine River and a small part on the right bank. While it is not true that the key advantages of the civic code and the code de commerce as compared to the reformed Prussian Land Law encompassed superior protection of property rights and equality before the law, as claimed by Acemoglu et al. (2011), the French law apparently allowed for more flexibility for out-of-court arbitration among businessmen<sup>29</sup>. Hence, the inhabitants of these regions made a plea in order to preserve the French law in their territory. However, after 1815 these laws were not imposed any longer and they were also not "entrenched". Rather, it was a deliberate decision of the Prussian government to keep the French laws in order to gain loyalty among their new citizens. In other parts on the right bank of the Rhine River, including most parts of the industrial Ruhr region, these laws were replaced by the Prussian Common Law (*Allgemeines Landrecht*). In the period of high industrialization, the region as a whole became an industrial powerhouse,

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<sup>29</sup> See Wischermann/Nieberding (2004, 82); for a highly-informed analysis of the institutional change in the Western territories of Prussia see Reckendrees (2010).

regardless of the civil code in place. As far as the German case is concerned, this kind of institutional variance seems to be less important for industrial development. There is no indication as to a differential development within the Ruhr region or the relocation of resources to the neighboring legal system, which would have been an easy undertaking.

A fully-fledged monopoly of coercive power of the state did not exist in Prussia until 1848. For a limited period of time, the landed gentry retained some state functions such as the patrimonial jurisdiction and police force in Prussia. Nevertheless, its role as one of the pillars of the state had already eroded. In other states such as Bavaria, the aristocracy became more pronouncedly downgraded on behalf of the monarch. Concomitantly, the bureaucracy (led by the reformer Montgelas) gained ground and conceived of itself as an instrument of public interest. Administrative reforms – realized to the greatest possible extent in Bavaria – protected the bureaucrats from arbitrary dismissal by the monarch. Governance became more independent from personal relations between the ruler and the other part of the dominant coalition. Legal rationality (Weber) became the dominant performance criterion of the bureaucracy, including performance-based opportunities of advancement, which made the bureaucracy largely independent of personal relationships. Corruption on behalf of the bureaucrats was prosecuted and entailed sanctions imposed by special disciplinary procedures, which prohibited arbitrary interference of the monarch.

The strengthening of an independent public administration entailed a major step towards the effectiveness of the rule of law. Hence, courts and public administrations escaped the control of the dominant coalition including the dukes and the monarchs. Basically, the idea of “*Rechtsstaatlichkeit*” implied a formal constitution in order to guarantee legal security, basic rights and to constrain the power of the state. Nevertheless, only the Southern German states had written constitutions after 1815, while Prussia did not attempt to do so after the Revolution of 1848. However, the growing independence of the bureaucracy was much more important for the guarantee of economic freedom than the establishment of a constitution. In the same vein, Zweynert (2011) stresses that the Southern German states, which had a constitution after 1815, introduced less economic freedom than Prussia.

### *The Cultural Influence of Enlightenment and Civil Society*

Additional factors conducive to the rule of law include the intellectual climate and political ideas.<sup>30</sup> During the 18<sup>th</sup> century, the tension between absolutism and the ideas of the

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<sup>30</sup> ) North repeatedly stresses the importance of ideas and ideologies for institutional change; for instance, see North (1990, 86).

Enlightenment became manifest and led to several conflicts. Distinguished philosophers, poets and men of letters (such as Kant, Goethe, Lenz, Schiller, Lessing, Nicolai, Mendelsohn or Schlözer)<sup>31</sup> criticized the privileges and the political prerogative of the nobility, which suggested its removal as the dominant coalition. While some monarchs adhered to their “divine right” of absolute rule (as in Württemberg), others such as the Prussian king committed themselves to the ideas of enlightenment, even though their promises were not enforceable.<sup>32</sup> Again, the diversity of German territories offered liberal intellectuals alternative locations if they were threatened by the authorities, which was supportive in undermining absolutist rule.<sup>33</sup>

The Napoleonic occupation and the period that followed offered better opportunities to realize liberal ideas as compared to the preceding period of “enlightened absolutism”. Without these ideas, however, reforms would probably have lacked a sense of direction. Adam Smith’s new political economy found a positive resonance among intellectuals (“the most beneficial book for mankind since the New Testament”) and inspired the reform thinking of administrators<sup>34</sup>; the universities of Göttingen and Königsberg became centers for Smithian ideas in academic life and shaped the thinking of influential reform-oriented bureaucrats (among them Schrötter, v. Schön, and Nicolovious; see Fehrenbach, 1993, 56 – 57).<sup>35</sup> They effectively opposed the advocates of the old feudal order such as Adam Mueller or v.d. Marwitz who intended to restore the ancient order before the Napoleonic invasion. Although the conservatives were backed by some parts of the dominant coalition, reform-oriented bureaucrats managed to pursue what is known as “defensive modernization”. Practically, reformers and bureaucrats saw their main task in guaranteeing a stable and foreseeable institutional framework which included economic freedom and the rule of law. (Wehler, Vol. II, 69). In spite of the lack of a formal constitution in Prussia until 1848, public administration established important elements of a de-facto constitution.

Caution should be exercised when drawing analogies between the early capitalist development of Germany and current transformation processes of autocratic regimes. According to NWW, limited access in politics is associated with a preponderance of the state as to the formation of economic and civil organizations. This is a common feature of current autocratic regimes. Open access orders, by contrast, imply “rich and vibrant civil societies with

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<sup>31</sup> ) See Fehrenbach (1993, 57)

<sup>32</sup> ) See Kant’s discussion with the Prussian king Frederick, who forbade written criticism of the church despite his liberal stance in many other affairs; see also Clark (2008, 293 – 332)

<sup>33</sup> One famous example is Friedrich Schiller’s escape from the absolutist state of Württemberg to the tiny states of Thuringia where the dukes guaranteed freedom of opinion and speech.

<sup>34</sup> ) See Kraus (1776) quoted by Wehler (2008, Vol. I, 405).

<sup>35</sup> ) See Priddat (1998) and Gray (1986) for the early reception of Smith in Göttingen and Königsberg.).

lots of organizations” (NWW, 11). Quoting Fukuyama (1995, 10), NWW argue that “a healthy capitalist economy is one in which there will be sufficient social capital in the underlying society to permit businesses, corporations, networks, and the like to be self-organizations” (Fukuyama 1995, 356 – 7 quoted by NWW, 7). As they convincingly demonstrate, open access orders as compared with limited access orders are characterized by a significantly higher number of organizations, whether they are profit, non-profit, or governmental.

If we follow this stance and take the extent of civil society as an indicator for the openness of the political order, the variety of organizations in early 19<sup>th</sup> century Germany is remarkable. Even in the incipient state of its development towards modern capitalism, society brought forth many organizations independent of the dominant coalition. Due to the religious divide in the German states, the state and the church were sufficiently separated from each other, which is why church organizations were not part of the hierarchy of the state.<sup>36</sup> In contrast to the goals of the French Revolution, the removal of the political power of the church was not an issue in Germany. Despite some group privileges bestowed to the Catholic Church as a compensation for secularization (some of which still exist), church organizations did not effectively hinder the development of capitalism. As regards the cultural life, which is included in NWW’s distinctive conception, it is certainly not true that the German states were deprived of a civil society, which poses a key difference to autocratic regimes. The pre-revolutionary period until 1848 witnessed an emerging civil society that organized itself in a variety of associations and organizations ranging from shooting and gymnastic clubs with hidden political intentions to cultural clubs, to literary and artistic clubs, singing societies, religious circles and worker associations.<sup>37</sup> Popular depictions of an authoritarian, centralized state which controlled civil society are a myth.<sup>38</sup> Thus, civil society benefited from the decentralization and rivalry of German states which in many cases rendered the repression of radical ideas ineffective. Fehrenbach describes the emergence of public discourse in 1791 and mentions 6000 professional writers, more than 1300 cultural, philosophical and political journals and affiliated “reading societies” as well as freemason lodges and “patriotic public associations” that were not only independent from the dominant coalition but also opposed the reactionary particularism of the princes (Fehrenbach, 1993, 57)<sup>39</sup>. The multitude and diversity of non-profit organization characterized the Age of Enlightenment and the period thereafter. It indicates that the dominant coalition did not exercise control with respect to the cultural life in society.

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<sup>36</sup> Only in a few archbishoprics which were dissolved in 1803, secular and clerical powers have not been separated.

<sup>37</sup> ) See also Kocka (Ed. 1995).

<sup>38</sup> ) Clark (2008) revises this depiction of Prussia which traces back to Marx, Veblen and Churchill.

<sup>39</sup> ) Among these journals, the “Berlinische Monatsschrift” as well as the “Allgemeine Deutsche Bibliothek” organized the public discourse; see also Gray (1986, 29).

*Further Steps towards Economic Freedom and Rechtsstaatlichkeit (Rule of Law)*

The creation of business organizations had been facilitated even before the institutional revolution of 1807 and 1811; in most territories public administration embraced the notion that monopolies impede economic development and thus undermine the economic power of the state. Therefore, entrepreneurs were allowed to obtain licenses if market entry stimulated competition with the incumbents.<sup>40</sup> After the sweeping institutional changes, administrative constraints for entrepreneurship were dramatically reduced and only kept in place for the mining industry (*“Direktionsprinzip”*) and for joint-stock companies. The former remained under the control of the state until the mid 19<sup>th</sup> century. During the 1850s, they were granted in the mining sector and later in the emerging railway sector (*ibid.*, 88). Besides, licensing for running businesses became standardized and thus stripped of the discretionary decisions of the authorities. Thereby, the economy was continuously emancipated from the paternalist state, occasional entrepreneurial complaints about red tape notwithstanding. As a result, the number of Prussian entrepreneurs rose from 14,000 in the 1820s to approximately 40,000 in the 1850s (*ibid.*, 82). Important firms that became drivers of industrial development were founded in the first half of the 19<sup>th</sup> century (among them Krupp in 1811, Stinnes in 1808, Borsig in 1836, Siemens in 1846, Carl Zeiss in 1846).

The revolution of 1848 – instigated by the February Revolution in France– failed to establish a democratic political order as intended by democratic leaders because the idea of democracy and full representation of the people turned out to be too radical even in combination with monarchy. As measured by its radical democratic ambitions, the revolution failed. Nevertheless, it prepared the ground for a constitution in Prussia and further steps towards the rule of law; the institutional requirements for open access to markets were realized while access to the political sphere remained limited. In contrast to former historiography, which solely concentrated on the retention of royal and the notability prerogative, Clark and Wehler stress the long-term achievements of the “failed revolution” with respect to equal rights (Clark, 2008, 574; Wehler, 2008, Vol. II., 776 - 779): Patrimonial courts in the East-Elbian lands were abandoned and replaced by official courts. Fundamental rights were formally guaranteed, such as the inviolability of the house, the freedom of assembly, the freedom of the press and speech, the independence of the judiciary (implying that judges could not be dismissed by the monarch),

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<sup>40</sup> See Wischermann/Nieberding (2004) who argue that in the late 18<sup>th</sup> century, the Prussian state generously allowed the foundation of firms and implicitly opened market access (*ibid.*, 63). Occasionally, the Prussian state protected firms from competition if they installed innovative technologies such as spinning machines (e.g. the patent for the Brüggelmann spinning company in Ratingen).

the separation of the judiciary from prosecution by the authorities, the prescription of public trials and the abolition of the death penalty except for capital crimes. The new constitutions deprived the nobility of all privileges in criminal prosecutions while its tax privileges remained intact. This further attests to the hypothesis that the rule of law should be analyzed as a matter of degree rather than kind.

Due to these legal and administrative reforms, the quality of institutions further improved as compared to the first decades of the century, which rendered the establishment of capitalism irreversible. Public administration became independent of the sovereign and strongly committed to legal rationality; corruption was nearly absent. Newly-established civil county courts lowered the transaction costs for firms (Wischermann/Nieberding, 2004, 152; Reckendrees, 2010, 59). Important reasons for a mutual dependency of open access in politics and economics notwithstanding, the history of the German states clearly illustrates that institutional development can take a different course. Legal security and the rule of law were provided as a *compensation* for the lack of political participation (Kirchheimer, 1967, 125). This social arrangement between the dominant coalition of the nobility and the bourgeois capitalists legitimized the order. Neither the sovereigns nor the nobility could afford poverty in their territory insofar as its eradication remained a feasible scenario. Acemoglu/Johnson (2012) neglect this problem by quoting Metternich's denial of Robert Owen's proposals for better conditions of the poor people: "We did not desire at all that the great masses shall become well off and independent [...] how could we otherwise rule over them" (ibid. 224 – 225).<sup>41</sup> This quote misjudges the requirements of legitimacy for political rule in Western and Central Europe. The period of pauperism in the pre-revolutionary "Vormärz"-period was caused by the incapability of the nascent industry to absorb the growing population and destabilized the political order.<sup>42</sup> When the early capitalist period in connection with population growth was not able to avoid pauperism in the 1840s, accelerated capitalist development was required to confer legitimacy upon the political order. This was conducive to the growing independence of the economy from the state.

Prussia as well as the Southern German states remained far from becoming open access orders as described by NWW; access to politics was limited. However, the strategic groundwork towards a capitalist transformation process was established which unfolded its economic effects in the decades to come. Rather than being a big bang transformation that established a blue print of capitalist institutions, defensive modernization successively relaxed

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<sup>41</sup> ) This answer by Metternich's assistant, Friedrich von Gentz, was reported to Robert Owen.

<sup>42</sup> ) Therefore it was a classical Malthusian subsistence crisis brought on by rapid population growth outstripping the productive capacity of the land.

binding institutional constraints which impeded the capitalist development. This type of institutional change is reminiscent of Rodrik's recommendation for contemporary transition economies.<sup>43</sup> It also reminds us that all-embracing (universal) notions such as the "rule of law", or the "equality before the law" can be misleading since the respective freedoms are a matter of degree rather than kind. The sweeping institutional change in the German territories is exemplary for a step-wise realization of economic freedom during a period which started in the age of enlightened absolutism in the 18<sup>th</sup> century and continued throughout the 19<sup>th</sup> century.

#### **IV. Conclusion: Stabilizing factors of capitalism without political participation**

Let us bring these historical findings to conclusion. The blueprint of a market economy is equal rights given to all members of society, which encompasses the rights constituting a market economy, among them the protection of property rights, the (internal and external) freedom of trade, the freedom to choose occupation, the freedom of movement and the right of abode. Courts and the public administration should not give preferential treatment to political incumbents. As the equality before the law is essential to a market economy in order to unleash competition, the dominant coalition must be deprived of its economic privileges, which is a recurrent theme in the political economy of Adam Smith as well as of modern institutional economics. Practically, however, all transformation processes retain certain economic privileges of the dominant coalition for a longer period of time than accounted for in economic models. The instantaneous removal of all privileges on behalf of a free-market society has rarely been observed in history, if it has ever occurred at all.

This prompts the idea of an interrelatedness of political and economic institutions. Unlike NWW's more complex analysis which shifts the attention to "doorstep conditions" for the transition to an Open Access Order, Acemoglu/Johnson claim a causal relationship between political and economic institutions.

"It is the political process that determines what economic institutions people live under, and it is the political institutions that determine how this process works. For example, it is the political institutions of a nation that determine the ability of citizens to control politicians and influence how they behave. This in turn determines whether politicians are agents of the citizens ... or are able to abuse the power entrusted to them" (Acemoglu/Johnson, 2012, 42).

The development of capitalism and the rule of law in early 19<sup>th</sup> century Germany defies this type of straightforward causality. Citizens in the German states were not able to "control politicians and influence how they behave" (ibid.). Nevertheless, the economic institutions of

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<sup>43</sup> See Rodrik (2007, 62 – 63).

capitalism emerged. NWW's explanation of mutual dependency regarding political and economic institutions is more complex and acknowledges that open access in the economy can precede political participation. Nevertheless, the emergence of capitalism in Germany likewise does not match NWW's explanatory framework. NWW share the view that democracy and full political participation form a political rule that allows for the check of economic privileges and gives way to open access in the economy. This prompts the question: How did inclusive economic institutions go hand in hand with exclusive political institutions for approximately 60 years?

One important factor lies in the above-mentioned rivalry among the states in Europe which put the dominant coalitions in the German middle states under pressure. Besides Prussia, other German states were sandwiched between Prussia and Austria, which spurred on liberalization that encouraged economic development. Now, liberal reformers in the public administration (most of them members of the dominant coalition) had good arguments for promoting their political project. In disputes with reactionary peers they pointed to the decline of those European nations that denied economic or judicial reforms (Venice, Poland). As regards the mighty Austrian empire, it was the delay of liberal reforms which eventually turned the balance in the Austrian-Prussian rivalry in favor of Prussia. There was no doubt that a prospering economy made up for the political power factor. Given the rivalry among the states, the interests of the dominant coalition ceased to be identical with the interest of the monarch or the "interest of the state". Officials in the public administration exploited this divergence in order to promote their reform project.

The German Custom Union in 1834 did not remove this rivalry, even though in retrospect it is often interpreted as a first step towards a unified German state. Most of the monarchies, duchies and grand duchies intended to remain sovereigns and opposed a political union. Five years before the unification in 1871, major German states such as Bavaria, Saxony or Hanover joined the Austrian empire in its war against Prussia and smaller duchies. In the first half of the 19<sup>th</sup> century, national unity remained a project of the progressive liberal movement rather than one of the conservative elites. However, the monarchs understood that the creation of a common market would further their economic interests that could be pursued without political ambitions of a central state. They supported the creation of a common market as a fundamental condition for a prospering economy in their territories. The expansion of the markets – furthered by trans-regional railway construction – encouraged entrepreneurs to issue large scale investments. Even after the unification of 1871, the member states had primary authority over the economy including taxation and regulation within their jurisdictions. The

states thus formed a system of market-preserving federalism based on economic rivalry and common markets (Weingast, 1995).

Highly supportive to the establishment of capitalist institutions was the separation of economic interests between the nobility and the incipient industrial capitalists. It was probably the crucial factor which prevented the relapse to a Limited Access Order. With few exceptions, the land-owning nobility was not engaged in the emerging industrial or banking sector. Furthermore, statutes for the nobility – that were confirmed in 1830 –formally prohibited industrial activities.<sup>44</sup> While the intention of this prohibition was the preservation of the feudal order, its unintended effect was the evolution of industrial capitalism. The formal – later informal – rules prevented the nobility from making use of its political power in order to create rents in the industrial sector. It had limited economic stakes in industry, while its economic privileges in the agricultural sector (namely tax privileges) did not impede capitalism.<sup>45</sup> Thus a “creative destruction” to the detriment of the nobility did not take place nor did it seem likely for the next decades in view of the growing population and rising demand for agricultural products. Therefore, the liberal reformers in the public administration were able to pursue a liberal agenda without facing political obstacles from the dominant coalition.

It is doubtful whether a better political representation of capitalists would have furthered this process. As in many other transformation processes, the incipient capitalism in Germany confirmed Adam Smith’s reservations about capitalists: far from being the natural advocates of a competitive capitalist order, they are intent on pursuing their own economic freedom at the expense of competitors by seeking protected monopolies. In the same vein, Wischermann/Nieberding (2004) reject the stereotype of businessmen who embrace dynamic capitalism. Well-established local firms attempted to protect markets by preventing outsiders from market entry (ibid. 73). If entrepreneurs had been more politically powerful, they would have had the possibility to protect their profits from competition. As regards Prussia the lack of political influence of capitalists kept rent-seeking behavior at bay. Rather, the public administration pursued its Smithian agenda and created a free-trade regime after the lifting of the Napoleonic Continental System. The administration showed no special concern with the industry in all parts of Prussia and dismissed requests for retaliatory duties in response to tariff protection in Britain and elsewhere.<sup>46</sup> One example is the textile industry in the Ruhr area which

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<sup>44</sup> ) See Gray (1986, 16)

<sup>45</sup> ) See Rasch (2006)

<sup>46</sup> ) See Koselleck (1989, 321 – 322); pointing to Adam Smith, Prussian entrepreneurs viewed themselves as “victims of abstract theories that are not confirmed by reality”, while Hardenberg argued that “public administration has to *explain* liberal economic policy to the public but cannot put the principles of free trade up for discussion” (ibid, own translation.). Industrial capitalists in Berlin praised the British tariff system and export

had been protected by the Continental System but then suffered from the sudden exposure to free trade. While American capitalists (as well as British capitalists until the mid 19<sup>th</sup> century) made use of their political power and influenced legislation in order to establish high tariffs, the early capitalists in Germany had to come to terms with the free-trade regime. In fact, tariffs in early 19<sup>th</sup> Germany were far lower than in Britain (up to the middle of the century) or the US throughout the 19<sup>th</sup> century.<sup>47</sup>

Prussian liberal economic policy culminated in the creation of a Custom Union in 1834 which abolished all interstate tariffs between some of the lesser German states and Prussia.<sup>48</sup> Tariffs on import products from other countries were kept low even though tariff revenues to be distributed to the German states surpassed all expectations. At the same time, the liberal project included the removal of trade barriers on the Rhine River, which promoted the transnational integration of the Rhine Prussian economy into the markets of Belgium, the Netherlands and England.<sup>49</sup> Tariffs for agricultural and some industrial goods beyond the low level of the Custom Union were not introduced until 1879, the period of high industrialization where protectionist measures ceased to be necessary for early economic development, provided that the “infant industry argument” is valid at all. Later on, agriculture and pig iron industry rather than the innovative industries of the so-called second industrial revolution (steel, chemical, electrical engineering) enjoyed protection, which puts Mises’ opinion regarding German protectionist industrial policy into perspective (Dedinger, 2006, 219). Indeed, Wehler emphasizes that early industrialists in Germany profited from free trade by means of imitation and reasonably-priced, semi-finished English goods (Wehler, 2008, Vol. II, 54 pp.). British export bans for machines intended to delay continental industrialization were not effective (even though they were sanctioned by the death penalty). The Prussian free-trade regime gives an example that learning and imitating can be profitable strategies for infant industries without tariff protection.

It is doubtful whether all newly established capitalist institutions, besides the abolishment of serfdom, would have found consent in society if the decision on them had come

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subsidies and bitterly asked: “Will our government preserve our existence or is our destruction a done deal?” (ibid. 321, my own translation). As illustrated by historical documents, German capitalists were unhappy about the fact that British industrial policy had a blind eye regarding the Smithian policy rules they had to obey.

<sup>47</sup>) See Dedinger (2006, 231).

<sup>48</sup>) The founding members were Prussia, Hesse-Darmstadt, Hesse-Kassel, Bavaria, Württemberg, Saxony and the states of Thuringa; Baden and Hesse-Nassau joined the Custom Union in 1835.

<sup>49</sup>) In 1868, all remaining obstacles to free trade were removed. This is probably the main reason for the economic prosperity of the region rather than the French occupation as stated by Acemoglu et al. (2009); while the French occupation isolated the region from the English market, the Prussian regime introduced a free trade regime that promoted economic growth in the region to the levels of the Netherlands and Britain. Hence, the argument by Acemoglu et. al. (2009) that the civil code introduced by the French occupation and retained by the Prussian governments has made the difference does not hold.

to a vote. The Southern German states offered better political participation due to their constitutions but lagged behind the economic reforms in Prussia. Guilds were not abolished before 1848 and were still considered a comprehensive social safety net. (Wischermann/Nieberding, 2004, 65). By contrast, Prussian craftsmen had to accept income losses due to the removal of the guilds. The state imposed its liberal agenda and deprived the cities of the right to determine economic institutions, their political autonomy after Stein's reform of the town charter notwithstanding.<sup>50</sup> No effective political measures were undertaken against the pauperism of the 1830s and 1840s in terms of market protection.<sup>51</sup> Instead, the economy became increasingly exposed to capitalist competition and institutions. As long as the industrial sector was too small, the social cost of capitalism absorbed public awareness, for which reason radical communists (Marx, Engels) and reactionary intellectuals (Adam Müller, v.d. Marwitz and Fichte, with modifications) agreed in their opposition to capitalism.<sup>52</sup> From the contemporaneous perspective it seemed unlikely that advancing capitalism could be the solution to pauperism rather than one of its causes. Even though the standard of living rose gradually, there is no evidence that capitalism would have found consent by citizens outside the dominant coalition. By now, the larger part of the population was far more affected by the creative destruction than the dominant coalition. Obviously this fact generalizes to many other transition economies.

The guarantee of its economic status-quo position made the land-owning nobility prone to accept capitalist institutions. As a result of the rising industrial sector, economic decline remained uncertain and only posed a remote threat, which explains why they came to terms with the sweeping change. However, the following development demonstrates that capitalism without political participation is a fragile social arrangement. When the nobility saw its own economic interests under threat, it did not hesitate to make use of its political influence. It successfully rejected taxes and shifted the tax burden to labor. When wheat imports from Russia put prices under pressure, the nobility passed tariff laws for agricultural products in parliament. Even though it lost more political privileges after the establishment of the parliament in 1871, it was still able to form a winning coalition in favour of tariffs to the detriment of the

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<sup>50</sup> ) Koselleck points to the local opposition against the abolishment of the guilds, which failed due to the decisiveness of the state; see Koselleck (1989, 591).

<sup>51</sup> ) Recently Pfister, U./ Riedel, J./ Uebele, M. (2012) have raised the question whether pauperism was only a local rather than a general phenomenon of that time; according to wage data average wages for industrial workers were rising in Germany even in the first half of the 19<sup>th</sup> century. This result is puzzling, given the wide discussion of pauperism in that time.

<sup>52</sup> ) Of course, the ideological differences are prevailing; as Goldschmidt in a comment of this paper argued, Adam Mueller favored a holistic approach to society which stressed the necessity of social inclusion of all layers of society.

underrepresented working class (Dedinger, 2006, 235). From that moment on, industrialists of pig iron became integrated into the dominant coalition (“coalition of rye and iron”). As a compensation for agricultural tariffs which increased living costs for workers, tariffs on some industrial products (namely pig iron) were introduced in 1878.<sup>53</sup> The free-trade idea began to erode, even though a fundamental change did not occur and new dynamic industries (such as the chemical and electrical industries) still operated without any protection. These later developments reinforced the public administration’s need for political support in order to retain liberal economic policy. If powerful groups oppose free trade and the countervailing power of the workers is still too low, the public administration could not pursue its liberal agenda of expanding general economic freedom.

The institutional analysis of nascent capitalism in Germany should not be mistaken as a normative argument for capitalism without political participation. NWW’s argument for a “double balance” between open access in politics and the economy is convincing. Economic and political freedom are coeval.<sup>54</sup> Nevertheless, German history gives an example that in a specific historical and cultural environment capitalist institutions and the rule of law can emerge without formal political freedom. In the later period of the 19<sup>th</sup> century, political participation gained ground. Even then, the regime did not open access to politics in the modern sense.<sup>55</sup> As the economy prospered throughout the pre-war period, economic performance was supportive to the legitimacy of the political order. The coincidence of a constitutional monarchy with parliamentary democracy and the rule of law backed the widely-held belief that the rule of law does not necessarily require political competition. As it turned out later, this experience did not generalize.

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<sup>53</sup> ) As Dedinger puts it, “imperial government ‘toyed’ with protectionism rather than decidedly embraced it” (Dedinger, 2006, 233).

<sup>54</sup>) For a theoretical investigation of the relationship and tensions from an evolutionary point of view see Wegner (2012, 2008)

<sup>55</sup> ) However, the Kaiserreich did not lag behind the standards of modernity of that time; see Kroll (2013).

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