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TABLE OF CONTENTS

THE ORIGIN OF THE PRESENT CRISIS IN WORLD HISTORY AND ITS LESSONS <i>Warren J. Samuels</i>	1
A P* MODEL ANALYSIS OF INFLATION IN PUERTO RICO <i>Carlos A. Rodríguez</i>	16
POLITICO-ECONOMIC TRANSITIONS: EVOLUTION AND GROWTH <i>Prateek Goohra</i>	41
AND, INJUSTICE FOR SOME: CORRUPT EXCHANGE AND THE RISK-AVERSE OFFICIAL <i>Gary E. Marché</i>	77
THE GENESIS OF CAPITALISM: THE NEXUS BETWEEN “POLITICS IN COMMAND” AND SOCIAL ENGINEERING <i>Li Xing and Jacques Hersh</i>	99

THE ORIGIN OF THE PRESENT CRISIS IN WORLD HISTORY AND ITS LESSONS

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Introduction

Political economy, as distinct from economics, emphasizes the problem of the organization and control of the economy, i.e., the structure of power. Not only are conclusions pertaining to economic welfare dependent upon organizational and structural variables—e.g., in the determination of whose preferences and interests are to count, and how much—but organization and structure are objects of control, precisely, in part, because they govern the distribution of economic welfare. Accordingly, struggles for power take place in all societies, and within states and between states.

One important concept in which much of the foregoing has been encapsulated is *imperialism*. That concept—including the further concepts of the structure of power, organization and control, and whose interests are to count—is at the heart of this essay and its companion essay (Samuels 2004), although I have made it explicit only in the latter.

This essay deals with the predicament—for the Middle East and for the world—posed by Israeli-Moslem relations and the role therein of the United States. This is clearly a struggle for power—power narrowly considered. More broadly, it is a resumption of the millennium-old conflict between Hebraic-Christian civilization and Islamic civilization—another predicament. Thus it is also a clash of religions and cultures—power broadly considered.

The companion essay dealt with the role in the world of the United States as the only so-called superpower, a superpower with interests it wants to project elsewhere

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and now a superpower exposed to non-state guerilla-type attacks.

I use the term “power” here precisely as I have in the past in other connections: participation in decision making (which may be deliberative and/or non-deliberative) and the bases thereof (Samuels 1992). Power is sought either to pursue particular substantive ends or to give effect to identity or ego gratification. Any particular conflict, such as that between Catholics and Protestants in Northern Ireland, is an amorphous admixture of motivations, a mixture whose elements—religious, political, cultural, and economic—in the case of particular individuals are difficult if not impossible to identify and measure unequivocally. This is true of both the individual actors themselves and analysts.

As in the case of economics, it is difficult to pursue political economy in a non-normative manner. In what follows I hope by the use of language to have made clear when I am describing, when I am positing a normative premise, and when I am prescribing.

The topics covered here and in the companion essay are, to put it mildly, tendentious. Because, in part, of the Holocaust, it is difficult, especially for a Jew, to treat Israel in a purely objective manner. Because the United States was arguably the first great liberal democratic state and its people enjoy both a high standard of living and relatively abundant and meaningful civil rights, it is difficult to treat it in a purely objective, or even a critical, manner. Because one abhors the events of 11 September 2001—and honors those who followed the injunction “Let’s roll,” in order to thwart one plane’s hijackers, along with Nathan Hale’s regret that he had only one life to give for his country and with the response “Nuts” to the German demand for surrender during the Battle of the Bulge—it is difficult to treat the perpetrators, for analytical purposes, in an objective manner.

But the policy analyst must think clearly. He or she must recognize that an assassination did not cause World War I: The assassination took place within a vast, if hitherto non-military contest for the control of Europe. He or she must recognize that the attack on Pearl Harbor was not an isolated event, but took place within a contest for the control of Asia and the Pacific.

Thinking clearly does not mean treating all sides and all policies equally. The policy analyst must be relativist. The relativist does not emphasize that one cannot choose sides but that one must examine alternatives objectively and that one must and indeed does choose. The relativist policy analyst balances two things: his or her choice between combatants, and his or her analysis of “terrorists” and “freedom fighters.” The relativist policy analyst appreciates how one person’s terrorist is another’s freedom fighter, and vice versa, and that they, too, are included in *governance*, as opposed to government—something the fanatic on either side cannot or will not fathom (Samuels 1995, 2001, 2002).

I. The Origin of the Present Crisis

There is no one preeminent cause of subsequent events; nor can one trace as yet unknown remote future consequences to selective contemporary events. Yet one can, if best in retrospect, identify certain lessons from the past.

During some point in the post-World War Two period it became reasonably clear that the origins—the seeds, as they were often called—of World War Two resided, to no small but still specifically immeasurable degree, in the treatment of Germany in the Treaty of Peace after World War One. It was, perhaps, not inevitable that reparations, coupled with hyperinflation, would engender the conditions that led to the rise of Adolph Hitler. The lesson—if only one of risk rather than of ineluctable

fate—was thereby learned that led to a very different policy toward Germany after World War Two.

Instead of backward-looking punishment, the policy of the conquering nations became forward looking, for the most part, that of enabling the reintroduction of Germany into the European economy and family of nations. The situation was complicated, to be sure, by the division of Germany into West and East and by new preoccupations with the Cold War. Indeed, the Western attitude and policy toward West Germany derived from the Cold War and the need for West German participation in the front against the Soviet Union and its satellites/allies.

While all this was going on, the seeds of the next great crisis in world history were sown.

The problem, as it were, was what was to become of the Jewish survivors of the German “final solution.” Widespread anti-Semitism—of which German policy was the most virulent form—was coupled with other exacerbating factors: a desire, in a war-tired world, not to have to face up to a vexing problem; the historically close relationship of Great Britain, one of the victorious allies, to the “Palestine problem;” the almost-immediate outbreak of the Cold War; and so on. All these circumstances combined to produce a vacuum and thence a failure of enormous proportions.

Great Britain was caught in a predicament of its own making. A modern imperial power, it (like Belgium, France, et al) sought to whitewash its more or less but nonetheless ever-present repressive and exploitative policies with the rhetoric of nation building. Very few of its colonies, perhaps only India, really were able to assume serious self-government after decolonization and independence was brought about. No doubt, this was partly also because colonial borders were meaningless in relation of ethnic/tribal groupings. Palestine, technically not a British colony, only a

protectorate under the League of Nations, was for Great Britain a problem and not an opportunity. But it was a problem related to an opportunity, the latter being good relations with the Arab states—a situation whose centers of gravity were European balance-of-power considerations and access to oil.

Into this situation came an invigorated, bellicose and eventually successful, Zionist movement. The movement itself, it now seems evident in retrospect, was not homogeneous. Among the leading elements were the reawakened Biblical promise of a Jewish homeland; the idea of a Jewish homeland as a bastion of security in a dangerous world; and other dreams of various sorts, including those of a secular labor-oriented or socialist state and of a Hebrew theocracy. Zionism united these and other motives and derived its strength from them.

Britain treated the Palestine problem, its Jewish problem, in much the same way that it handled other foreign affairs of state—as an imperial power. It did not seriously take up the question of state making. Any element of state making entered largely as a derivative of Britain seeking its interests and in its playing Moslems and Jews against one another.

Nor was the role of any other nation, not least that of the United States, any more affirmatively constructive. Other nations were quite happy, on the one hand, to attend to their own problems and, on the other, to leave the matter of Palestine to Great Britain.

The result was the successful insurrection of the Jews against the British overlords and the establishment of a Jewish state, Israel, in Palestine.

But Palestine was not an otherwise empty land. Palestinian Arabs, largely Islamic, also lived there—and they had fellow co-religionists in neighboring states. The result was series of Arab-Israeli wars and a general policy by Israel with which it treated the Palestinians in much the same repressive and exploitative way that

Hitler had treated the European Jews. I say much the same and not the same because the Jews have not undertaken against the Palestinians the systematic murder and extermination that constituted the Holocaust. Yet even that is laden with irony. First, the Israelis seemed to have learned nothing from the Holocaust about the moral and humane treatment of other people. Second, the Palestinian refugee camps, marked by squalor and despair, have generated an anti-Jewish fundamentalism and fanaticism similar to that which fed the Holocaust. And third, the anti-Israeli fanaticism threatens its own Holocaust.

The seeds of World War Two were inadvertently sown by the aggressive policies built into the Treaty of Versailles. The seeds of the present predicament—that burgeoning conflict between Western civilization and Islamic civilization—were inadvertently sown by passive policies that, in effect, allowed Zionism to take upon itself the problem of state making in Palestine, now Israel. However, such state making was an effective monopoly of the new Jewish state; and its policies were, in part, calculated to foreclose the development of a rival Palestinian entity.

The passive policies were not only those of the United States and the nations of Europe. They were also those of the Arabic states in what was soon called the Middle East. If the Palestinian cause was a thorn to the Israelis, it was likewise one to the established Arab states.

In short, no one—except the Israelis and eventually the Palestinians—was interested in state making in the area, and until recently the balance of mutual coercion in the area was enjoyed by the Israelis.

One cannot say with any degree of confidence what would have happened if the Allies had attempted to work out a solution more or less mutually satisfactory to the Palestinian Arabs and the Israelis, say, before the insurrection against Britain. It is quite likely that no

permanent peaceful solution would have proven feasible. In that case, the better part of wisdom might have been the non-triumph of Zionism. What the frustrated Jews would have done, one can only guess. In another scenario—of which there are many—Jews and Palestinian Arabs, and perhaps other Arab states, might have been able, under the auspices of a post-World War Two conference, to work out a feasible solution—before Arab frustration took hold. A further complicating and exacerbating factor was for many years the policies of the Soviet Union, which sought to extend its influence in the region.

One can say with a reasonable degree of confidence, however, that the result effectively engendered by the triumph of Zionism coupled with the antagonism of the Moslem world, facilitated by the passive and hardly benign neglect by the nations of Europe, has led to the present situation.

Ironically, only the United States, in various administrations, has made serious and continuing efforts to bring about a peaceful solution in the Middle East. Yet the irony deepened. The initially precarious position of Israel, undergirded by the moral sentiments of a liberal democratic society and by the influence of the Zionist movement in American politics, led the United States pretty much to give Israel a blank check in matters of domestic policy. Neither Hebrew religious fundamentalists nor the settlement policies of a series of Israeli governments were ever seriously or effectively called into question. Yet it was the former which led to the latter and it was the latter, coupled with other policies, which led to the inability to work out a peaceful solution.

The lesson of the Treaty of Versailles was that in modern times former enemies should, to the advantage of all nations and peoples, be encouraged and facilitated to reenter the family of peaceful nations and to follow a

policy of live and let live. The failure of the post-World War Two period was that European reconstruction and state making included neither the Jews nor the Arabs.

Again, one cannot say how much peaceful equilibrium could have been achieved, and for how long, as between Judeo-Christian and Arab-Islamic civilizations, between modernist Western nations and mediaeval nations. But the situation could hardly be worse than it has become. The situation is so bad that it has led some people openly to state, if sometimes ironically, how much better life and the prospect of the future was during the later years of the Cold War—even with, indeed perhaps because of, the policy of mutual assured destruction (MAD) pursued by rational, non-fanatic decision makers.

Can the situation be reversed? Is it too late?

II. Solutions

It may well be too late. But if there is to be a chance for reversal, something like the following may be required.

All peoples and nations will have to understand that ideology and religion are not given and absolute but are objects of social construction. There is no “true” form of any religion, only various competing uses to which a religion may be put. No one declarer of the meaning and application of a religion derives same only from the religion itself; each, rather, would restate, redirect and reconstruct the religion to suit their own purposes and selective understandings. All peoples and nations will have to understand that political claims stated in ideological and theological or religious terms are not necessarily superior to other modes of making claims, but are selective quests for power, however well meaning or not, garbed in the vestments of religion. All peoples and nations will have to understand that

explanations of secular and natural phenomena stated in ideological and theological terms are not necessarily more correct than nonreligious explanations. All people will have to cease intruding politics into religion and religion into politics, no longer using the other for their own secular purposes. All peoples and nations must cease making invidious comparisons between their own and other civilizations. All peoples and nations will have not only to reckon with their neighbors but understand that it is both morally desirable and in their respective interests to do so. All peoples and nations must follow a policy of live and let live toward their neighbors.

All peoples and nations must make serious and sincere, well-funded efforts to promote understanding of both other peoples and the grievances of other peoples.

All peoples and nations must be open to the operation of the principles of approbation and disapprobation by which critique of their organization and behavior may be rendered.

All peoples and nations must be subject to international rules and adjudication of conflicts—between nations, between ethnic groups, between other groups—all conducted in such manner and with such results as to prevent and resist organized violence.

The Israelis will have to cease justifying and believing in the justification of their policies in terms of propositions either found in or derived by interpretation of the Old Testament.

They must fundamentally transform their attitude toward and relationship with the Palestinians.

They must cease the policies that treat the Palestinians and other Moslems as if they and their interests did not count.

They must reverse the policies of successive Israeli governments that have sought to dominate and oppress the Palestinians.

They must seek to redress the Palestinians' grievances, whatever the Israelis' own. How they do this, with what degree of disclosure, in what steps, etc. cannot be spelled out in advance but must be negotiated in good faith.

They must cease the fanaticism that is calculated to prevent mutual accommodation of interests. The present Israeli government must cease taking advantage of the actions of Hamas and other groups in order to avoid working out a solution to the situation. The government's actions have played into the hands of Hamas and the actions of Hamas have played into the government's hands.

Not the least negative contributing factor has been the policy of settlements; but there have been others. The policy of settlements must be reversed; the settlers, whose presumably well-meaning intentions have been deployed in pursuit of a policy of delaying the reaching of accord with the Palestinians, must be both made to see this and helped to adjust. Similarly, displaced Palestinians must be meaningfully assisted; the doctrine of a policy of return must apply to Jews and Palestinians alike, not unequally in pursuit of an electoral majority.

The Israelis must acknowledge what they already know, that if the situation were, somehow, reversed, the Israelis would act—as they did in the case of Great Britain—pretty much as the Palestinians and their ostensible allies do today.

Israel must reverse its policies toward the Palestinians. If Israeli policies are changed, the effort may fail, it may succeed. To undertake such a reversal will take much courage, it will involve a fundamental change in the politics of Israel. It will involve having to work out solutions to a host of collateral problems and future developments of which no one can as yet be cognizant—including the possibility of dangerous behavior by hitherto implacable enemies. To not reverse

course, however, is to invite the return of the Dark Ages. To reverse course is still to risk that return but it also can enable its avoidance.

If Israeli policies are not changed, the results will be dire and our future is doomed. Part of that future will be the attribution of blame to Jews and Israel—with enough apparent evidence to render the attribution seemingly unequivocal. The renewed and exacerbated warfare between Judeo-Christianity and Islam will be traced, in no small part to Jews.

The Islamic peoples will have to cease believing in the justification of their policies in terms of propositions either found in or derived by interpretation of the Koran.

They must fundamentally transform their attitude toward and relationship with the Israelis and other nations.

They must cease the policies that treat the Israelis and other peoples as if they and their interests did not count.

They must seek to redress the Israelis' grievances, whatever the Palestinians' own. How they do this, with what degree of disclosure, in what steps, etc. cannot be spelled out in advance but must be negotiated in good faith.

They—including Hamas, etc.—must cease the fanaticism that is calculated to prevent mutual accommodation of interests.

They must take seriously and seriously study the critique of Islamic civilization rendered by modernist civilization, in a spirit of live and let live.

The United States—and, *pari passu*, all other nations—will have to continue the policy of guaranteeing the existence of Israel, with a view that the need for such a guarantee will atrophy as a new and peaceful order is constructed in the Middle East.

The United States and other countries will provide economic and other assistance to the Middle Eastern countries in such manner as seriously and sincerely

promises to promote broad-based economic development.

The United States will not support Israeli policies that oppress the Palestinians and/or function to delay peaceful mutual accommodation of interests; indeed, the United States will withhold assistance to any nation that manifestly oppresses its neighbors and seeks to delay peaceful mutual accommodation of interests, even at the price of sacrificing other interests by the United States. This includes the Israeli policy of settlements.

The United States, in particular, must take seriously, and seriously study, the critique of its policies and civilization by other nations and civilizations, in a spirit of live and let live.

The United States has long been the harbinger and symbol of liberal democratic society. The spirit of its constitution has been widely emulated. The life of its people has been widely sought by generations of immigrants. That the United States, through often well-meaning but ill-conceived policies, has gained the fanatical enmity of large numbers of people must give it cause to reconsider those policies and the manner in which they are adopted and deployed.

III. Prospects

None of the foregoing reduces, for any nation, to a readily available black box, calculus, or litmus test by which policy may be determined. Identifications of problems and of solutions to problems, and hosts of problems of means-ends relations, will still have to be worked out. Such, one hopes, will be facilitated by a truly informed citizenry, not one deluded into thinking either that collective life is necessarily in conflict with individual autonomy or that only one blueprint for collective life is proper.

The chances of realization for most if not all of the foregoing, however, are slim. The seeds for further conflict have already been sown, and they likely will be expanded through both further actions of commission and of omission. The foregoing is largely wishful thinking.

We have more or less vague ideas of the actual intentions of the various parties to the conflict. And intentions pale before unintended consequences. The goal of Osama bin Laden and others may be the removal of non-Islamic foreigners from Saudi Arabia, the ouster of the current Saudi regime, the capture and control of Middle-East oil, the radicalization of Moslem populations and governments by Islamic fundamentalism, the reversal of a millennium of felt Islamic repression at the hands of predominantly Christian countries, retribution for Israeli and U.S. Middle-East policy, and so on. Even if any of these are not intended they well may become—indeed to some extent have already become—the unintended consequences of past policies.

It well may be too late; the seeds planted during the last half-century are germinating. But it is not too late to try to reverse matters.

The U.S. must continue to support the existence of Israel. Any anti-Zionist sentiment to the contrary is wishful thinking. But it need not continue to support any and all of the misguided policies of the Israeli government. That government must be taught that it is in the interests of the Israelis themselves and of many other peoples—including the U.S.—for Israeli policy toward the Palestinians to be reversed.

That such policy reversal by the U.S. is one of the goals of the Islamic fundamentalists does not make it wrong. They have also objected to the U.S. acting, in its own view as a superpower, as a world-class bully—and many Americans have thought so also, just as many

Americans, including many Jews, have found Israeli policy toward the Palestinians to be repugnant.

Nor should such policy reversal by the U.S. be accompanied by forgiveness of what happened on September 11, 2001. The U.S. can and should wield its big stick in such cases. The U.S. also can and should show that it is big enough and confident enough to admit to past mistakes.

One of those mistakes was the error of omission in which no effort was made to organize post-war reconstruction in the Middle East. The U.S. should promote such reconstruction under the auspices of an international agency. Some or much of the financing should come from revenues from the sale of Middle-East oil. If western capitalism is not to the liking of Islamic peoples, they can try to tone it down and accommodate it to their religion. They can also do one other thing: They can remove and replace regimes in which mediaeval rulers and ruling families treat national resources as their own and ignore the poverty of their people while they live in regal splendor.

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Warren J. Samuels is Professor Emeritus of Economics at Michigan State University. This paper was written in early 2002 and is dedicated to the memory of Murray Wolfson, late Professor of Economics at the California State University, Fullerton. It is a companion piece to "The Crisis in US Foreign Policy," which appeared in the June 2004 issue of this journal.

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A P* MODEL ANALYSIS OF INFLATION IN PUERTO RICO

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Abstract

One can analyze and forecast the inflationary potential in the Puerto Rican economy using the "P model." Given the nature of the monetary sector in Puerto Rico (PR), the model is put into the context of variables from the mainland United States (US). The results indicate a long-run relationship between the money supply (M1) of the US and the price level in PR, between M1 and real production in PR, and between M1 and the prime rate in PR. The implications for forecasting and policy are discussed.*

JEL Codes: C32, C52, C53

Key Words: Econometric Modeling, Time Series Analysis, Forecasting Methods, Monetary Economics.

I. Introduction

Inflation is a global problem almost all countries have suffered from one time or another. Due to the recent history of high inflation in Latin America, many governments still hold the management of the price level as a primary objective of policy. In a number of countries in the region, high inflation rates have negatively impacted levels of investment while also distorting the

tradeoffs between consumption and saving. Puerto Rico (PR) is unique in that the commonwealth government has not considered inflation in its policy agenda. Nevertheless, inflationary pressures in PR exist and one need only point out that factor price increases in raw materials, salaries, intermediate inputs, etc., have had a direct effect in destabilizing the economy of island over the last thirty years.

The main reason for ignoring inflation in PR owes greatly to the relationship of the island with the mainland US. A majority of imported products, be they final goods or intermediary, hail from the mainland. Likewise, the minimum salary is determined in Washington and the currency is the US dollar. Puerto Rican politicians have made the assumption PR is a price(-level) taker.

Given the adverse effects of inflation on the island, one should question the price(-level) taker assumption and understand the *degree* to which commonwealth public policy may control inflation. One may turn to P* model as an indicator of the evolution of magnitudes of price levels and expected inflation. (see, for example, Hall and Mine, 1994; Hallman and Anderson, 1995; Orphanides and Porter, 1998; Galindo, 1997). The P* model arose out of the necessity to estimate the relationship between monetary aggregates and production levels; indicators are sought for long-run tendencies in the price level. The model has also been used to gauge the feasibility of economic policy in the control of price levels (Allen and Hall, 1991). Its advantage lies in the capacity of the model to forecast prices using simple rules regarding movements in production levels and monetary aggregates. Nevertheless, such forecasts assume the circulation velocity of money is a constant and that one can use the interest rate as a proxy for the opportunity costs of money (Orphanides and Porter, 1998).

The P* model measures inflationary potential by estimating the price level toward which the economy is

* The author wishes to thank Professors Joseph Vogel, Juan Lara, and Wilfredo Toledo, for their helpful comments and suggestions.

adjusting in the long run as a function of the quantity of money in circulation (Galindo, 1997). Equilibrium is assumed in the long run for both the circulation velocity of money as well as the corresponding level of production. Any permanent change in the circulation velocity of money or in the level of potential production would generate a permanent divergence between the real price level and that forecasted by the model. Therefore, the estimated value of the price level in the long-run can serve as a robust indicator of current monetary conditions.

Despite encouraging empirical findings from the P* model, some authors (Orphanides and Porter, 1995; Arnold, 1995) question the causality between price levels and monetary aggregates. Inasmuch as production levels are a function of expectations, the circulation velocity may also be a function of expectations. In the case of Puerto Rico, the money supply is endogenous to the market and not administered by the government or any other autonomous entity in the island.¹ Given such dependence, one quickly deduces that PR has little to no control over the evolution of inflation and cannot target price levels by means of monetary policy. Similarly, given the asymmetrical relationship between the two economic systems, the price-level in PR does not significantly affect the price-level on the mainland. However, this high degree of dependence of the island economy may throw doubt on the assumption of a stable circulation velocity of money. To understand the instability, the P* model will estimate the error correction

¹ Due to a high level of integration of capital markets with the mainland US, the economy of PR is not affected significantly by international economic instability and external flows of capital.

by considering the prime interest rate as a measure of the opportunity costs of maintaining money balances (Rodríguez y Toledo, 2003). The following application attempts to analyze not only the impact of inflation on the island economy but also the role the P* model may play in the public policy debate.

II. The history of inflation in Puerto Rico

PR became a Commonwealth of the US in 1952. The negotiation of Commonwealth status culminated in a Puerto Rican constitution that would specify the areas of intervention between the federal government of the US and that of territorial government of PR. Although the constitution of PR did not really change the fundamental relationship between the two governments, the new status was nevertheless beneficial to the dominant political party in PR (Partido Popular Democrático) as well as to Washington, as it seemed to address the United Nations mandate for decolonisation (Villamil, 1975). Coincidentally, the political settlement of commonwealth status accompanied the emergence of the US as the dominant country throughout the world. The island quickly became a logical choice for US hegemony in both political and economic terms in the wake of the Second World War and the onset of the Cold War, with all its concomitant military expenditures.

Given the geopolitics of the day, Washington gave priority to resolving long-standing problems in PR through an economic strategy of development through investment and export. In exchange, the PR government would show flexibility and abandon its previous reform program. For example, in 1947, the First Law of Industry Incentives (Ley de Incentivos Industriales) was approved which gave a tax holiday on profits for foreign companies working on the island. The following year, in a show of liberalization, the government of PR would sell the

factories it had recently sponsored under the program of *Fomento*² The objective of both moves was to attract a variety of industries to the island and the model of development became known in English by the metaphor “Operation Bootstrap” or in Spanish “Operación Manos a la Obra” (literal translation: Operation-Hands at Work).

Through the fiscal incentives of Operation Bootstrap, the island began industrializing and fundamental transformations took place in the productive processes of the island economy. During the initial phase (1947-1956), labor-intensive light manufacturing was attracted (Departamento de Comercio, 1979; Dietz, 1989; Villamil, 1975), consisting primarily of textiles which consumed little energy and generated low levels of pollution. However, textiles are a quintessentially competitive industry and generated only low levels of profit. The comparative advantage in textiles shifted quickly in the wake of the Kennedy Round of the GATT negotiation, which lowered tariffs on labor-intensive manufacture from the Far East. In other words, any efficiency advantage of the island in the production of textiles did not compensate for the differential salaries between PR and, say, Hong Kong. This deteriorating comparative advantage was accentuated by implementation of the US federal minimum wage in the island. One can even say that, during this period, inflation was driven by compliance with the mandated US minimum wage floor.

The second stage of industrialization (1956-1973) witnessed construction of refineries and a large-scale petrochemical industry both, driven by a federal quota system that apportioned importations of petroleum to

² A national and international boycott of the government financed factories (*Fomento*) also precipitated their closure. Nevertheless, the closure may also be attributed to the difficulties in establishing distribution channels with the larger market (Lewis, 1949).

distinct states. The absolute and relative role of labor diminished with respect to capital during this second phase.³ Inasmuch as both refineries and petrochemicals are highly energy-intensive, both would also be highly polluting. (Commerce Department, 1979; Dietz, 1989; Villamil, 1975). Therefore, the subsidy was both fiscal and environmental. The hope of the island government was the development of oil-refining capacity would generate supplies of intermediary products for local industry while also reducing the energy dependence of the island. For example, an ample supply of relatively low cost electric power would facilitate energy-intensive industries like aluminum, broadening the raw material base of PR. However, that did not happen. Industry tended to prefer proximity to its markets rather than proximity to its inputs. (Villamil, 1975).

One can argue that Operation Bootstrap made PR little more than a “manufacturing enclave” within the US. The sole advantage for PR seemed to be the employment that would be generated from final assembly; the disadvantages appeared manifold. The latter begin with the fact that most businesses were administered from the US, employing almost no local management; likewise, the lion’s share of inputs came from the mainland. Local light industries would now have to compete directly with those from the mainland whose variable costs were far lower. For these industries, factor prices had increased, thereby aggravating already extant structural problems. The tourism sector was also not exempt from these costs increases, which were compounded by high transportation costs to/fro the

³ As seen in Box 3 of the Appendix (Statistical Series), the mean of gross internal investment in fixed capital went from a minimum value of 73.9 million dollars in 1947 to a maximum value of 973.5 in 1972.

island. To make matters worse, the government did not undertake an adequate promotional campaign to promote the island on the mainland. Generalized factor price increases were exaggerated in food markets due to quasi-monopolistic conditions and, in 1974, the Planning Board of PR formally called for expansion of the antitrust section of the Justice Department and for a clear policy that would deploy the Import and Distribution Corporation to encourage competition. The fact that nothing happened is evidence of the political strength underpinning the structural problems on the island. For the most vulnerable segments of the population, faced with high price levels and low levels of employment, migration to the mainland became the relief valve (Perloff, 1952). Nevertheless, migration and the subsequent remittances did not resolve the economic instability generated by inflation and unemployment.

By the mid-sixties, measures were being proposed to address the structural problems of integration with the federal system. Among the proposals were certain job classifications being exempt from the US minimum wage, the reduction of legal holidays, and a moratorium on new fringe benefits. Restrictions on foreign investment was also discussed in the context of the possibility that the majority of Puerto Rican government bonds might end up in the hands of foreign investors aggravating the political dependency of the economy and leading to the real possibility of capital flight, with all the attendant negative impacts for public finance. Such arguments were generally ignored.

The year 1976 may be considered a watershed in the economic development of PR. For the previous thirty years, the strategy of economic development had been based on attracting foreign capital via tax holidays, *de jure* and *de facto* subsidies (infrastructure and the environment) and relatively low salary scales (Quiñones,

1994). Section 936 of the Federal Tax Code⁴ of 1976 took effect and granted a credit for income generated from assets and liabilities originating in PR as well as for taxes paid on foreign income. A deduction would also apply to dividends remitted to the parent company (Junta de Planificación, 1994; Ruiz y Zalacaín, 1996). Most of the multinational companies who responded to these fiscal incentives hailed from the US.

Section 936 was created to attract foreign investment in PR and offset some of the negative impacts of compliance with other federal laws, viz., the minimum wage and the Jones Act⁵. There is little doubt the incentive package enabled the development of a high technology sector on the island which would become one of the most dynamic sectors (Quiñones, 1994)⁶.

⁴ The antecedents to Section 936 originate in 1921 with Section 262. Section 262 of the Federal Income Tax Code was designed for US companies established in the Philippine Islands, then a possession of the US. The requirements to qualify for exemption under the Section were: at least 80 percent of the income would originate from commercial activities in the possession and 50 percent or more from incomes that originated in company operations in the possession (the condition 80-50). In 1955, this law was incorporated into the Federal Income Tax Code as Section 931, which continued offering a full exemption to incomes generated from US corporations in Puerto Rico, American Samoa, Guam and the Panama Canal.

⁵ The Act requires island-mainland ship transportation fly under the American flag (one of the most expensive in the world), imposes US citizenship on Puerto Ricans, and reserves to the US all powers correspondent to customs, immigration, mail services, maritime law, defense, commerce and all matters relating to sovereignty.

⁶ More than 60 percent of the 936 firms are in clothing, pharmaceuticals, machinery, and scientific and professional instrumentation (Catalá, 1993)

Businesses operating under Section 936 generated, both directly and indirectly, a large number of jobs and investment. The new activity also contributed to the tax coffers of the island through taxes on the repatriation of profits, income, and patents. Nevertheless, President Clinton overturned Section 936 on August 20, 1996 and a transition period was established for the phasing out of the incentives. During this period, the government is to seek new stimuli for industrial development. However, the flaw in such reasoning is the assumption that PR enjoys instrumental complementarity; indeed, the only significant attraction of capital to the island seems to have been the tax incentives (Catalá, 1993).

To this day, the nature of the problem of economic development in PR is not really distinct from what it was thirty years ago. None of the measures inspired by the various development models has fundamentally resolved structural problems of development. One sees persistent economic instability as well as a recent decline in the real Gross Domestic Product, a high level of unemployment and a downward cycle of fixed capital investment accompanied by inflation rates higher than those on the mainland. Nevertheless, the standard of living of Puerto Ricans does not seem to have borne the full brunt of this instability, cushioned by federal transfers and public and private debt that, in turn, translate into inflationary pressures from the demand side.

In summary, one can say that the inflation in Puerto Rico over the last generation originates more in the supply side than in the demand. The evidence suggests that inflation in factor prices has led only partially to heightened consumer demand. For example, the very high population density of the island and its legal status within the US, translated into steady and significant increases in the real price of land. To the extent that locally owned assets (e.g., land) were being liquidated for consumption, the causation of inflationary pressure

runs from the supply to the demand side. Unraveling the inflationary behavior of the Puerto Rican economy can help policy-makers perceive what measures are indeed available to them and thereby challenge the facile assumption that the island is merely a price(-level) taker.

III. Putting the model in the context of Puerto Rico

With the widespread assumption that inflation is lockstep with the US economy, there has been an absence of analysis of the evolution of inflation in PR. No consensus exists among economists in PR regarding the variables that determine inflation on the island nor any consideration of the possible role of public policy. To fill this lacuna, the following P* model is proposed as an indicator for expected inflation. The advantages of the model can be itemized:

1. One can include internal variables, like production level in PR, as well as the usual variables of the US economy that directly affect the magnitude of inflation.

2. One can forecast prices based on patterns in the behaviour of production levels and monetary aggregates, assuming the circulation velocity of money is constant as determined by the opportunity costs of money (Orphanides and Porter, 1998);

3. One can identify inflationary potential by estimating the price level to which the inflation will tend to adjust in the long run, as these are a function of the quantity of money in circulation (Galindo, 1997). Such estimation is grounded in the assumption that the circulation velocity of money and the potential production will seek equilibrium levels in the long run.

4. By comparing the real level of prices to that forecasted, one can also identify permanent changes in the national economy with respect to the circulation velocity of money or in the potential production level

A word of caution: because the island does not have *absolute* control over inflation, traditional monetary policy is not possible nor could the island ever impact the US variables in the model. Despite this, the P* model can be used as a general identity to analyze the behavior of the inflation rate in PR and the inertial effect based on the estimation of an error correction model.

One begins by considering the peculiar relationship of the economy of PR to that of the US. In a number of works, inflation in Puerto Rico has been found to be a monetary phenomenon. Toledo (2000) finds it so in both the short run and long run and claims a relationship of co-integration exists between inflation in Puerto Rico and the monetary supply in the United States. This result was also supported in a simplified IS-LM model of the Puerto Rican economy. (Rodríguez 2002)

The scenario described above has been greatly complicated by unanticipated interventions in US monetary policy, whose reverberations pass through the interest rates on federal funds. Such events impact unemployment and inflation in PR for a prolonged transitional period as the island economy is not resilient to immediate shocks. Toledo y Rodríguez (2003) have found both inflation and unemployment rates respond to the reduction in the interest rate on federal funds. The temporary effect of an increase in the federal fund rate to the inflation rate is negative but the permanent effect is positive. As expected, the unemployment rate tends to decline as a result of falling interest rates.

One can conceptualise the interest rate as a mechanism of transmission for the monetary policy of the US on PR. This means that the economic agents in PR should take into account fluctuations in the magnitude of US monetary policy instruments, which will subsequently generate macroeconomic shocks in PR that reverberate over time.

IV. Theoretical Framework

The P* model is based on the feasibility of using a monetary aggregate with unitary elasticity with respect to prices as an indicator of their the long-run relationship. It is an expression of the quantitative equation of money (Galindo, 1997; Orphanides and Porter, 1998) using the United States money supply:⁷

$$M_t V_t = P_t Y_t \quad (1)$$

where:

M_t = money supply of the United States;
 V_t = money circulation velocity in Puerto Rico;
 P_t = level of prices of Puerto Rico;
 Y_t = national production of Puerto Rico.

The equilibrium level of prices (P*) can be obtained from (1):

$$P_t^* = \frac{M_t V_t}{Y_t} \quad (2)$$

Applying natural logarithms, the estimation of (2) is represented by:

$$p_t = \beta_1 m_t + \beta_2 y_t + \beta_3 v_t + \varepsilon_t \quad (3)$$

where the lowercase letters denote natural logs. In this equation $\beta_1 = 1$, $\beta_2 = -1$ and $\beta_3 = 1$. The equation also

⁷ Although the variable M1 is a saving and transactions instrument, it shows a great structural stability with the variables of study.

presents a simple rule to forecast behavior of prices, assuming that the velocity of money is constant. A way to improve the predictive capacity of the model, without unduly complicating it, is to estimate separately the circulation velocity of (3) and then substitute that value for the vector z_t . Such a procedure allows a better simulation of the circulation velocity of money in PR and facilitates the search for a less restrictive form that incorporates the distinct dynamic responses of changes in the money supply and the level of economic activity.

$$p^*_t = \beta_1 m_t + \beta_2 y_t + \beta_3 z_t + \varepsilon_t \quad (4)$$

$$\varepsilon_t \sim N(0, \sigma^2)$$

A typical short-cut is to substitute the interest rate for the velocity of money. The use of the interest rate can be defended given the dependence of the island economy on that of the mainland and the correspondence between circulation velocity of money in PR and the prime interest rate in the US. The long-run relationship between the money supply and the prime rate of the US and real production and the level of prices in PR This is also corroborated with empirical evidence (Rodríguez, 2002; Toledo, 2000). So, the prime rate is presented as an approximation of the circulation velocity of money and equation (3) can be rewritten as

$$p_t = \beta_1 m_t + \beta_2 y_t + \beta_3 r_t + \varepsilon_t \quad (5)$$

$$\varepsilon_t \sim N(0, \sigma^2)$$

where $\beta_1 = 1$ and $\beta_2 = -1$ and $\beta_3 = 1$ (Hall and Mine, 1994; Bordes, Girardin and. Marimoutou , 1993).

Equation (5) is then estimated using the Johansen procedure (1988) to determine the presence of co-integration. Such determination is necessary when a combination of variables exist that share similarity in the

order of integration, suggesting the necessity of using series that co-integrate to obtain unbiased and consistent estimates and, thereby, avoid the problem of spurious correlation (Rodríguez, 2001). When a relationship of co-integration is present in the series, the residual variance is minimized in the parametric space and the resulting estimates are highly consistent and will converge on their true value. (Rodríguez, 2001; Novales, 1997; Maddala, 1996; Johnston y DiNardio, 1997)

If the specification of the existence of this phenomenon is in error, one will accept as valid those relationships that are merely spurious in the process of drawing inference (Bhargava, 1986; Maddala, 1996; Maddala and Kim, 1998; Enders, 1995). In terms of political economy, this means that an incorrect execution of the analysis, will lead to erroneous conclusions in policy making (Rodríguez, 2001). Such caution is warranted for any econometric model that uses time series.

If there is a co-integration relation among the variables in the model, the short-run dynamics of this relationship can be represented in an error correction model:⁸

$$\Delta p_t = \alpha_{11}(p - p^*)_{t-1} + \alpha_{12}\Delta p_{t-1} + \alpha_{13}\Delta m_{t-1} \quad (6)$$

$$+ \alpha_{14}\Delta y_{t-1} + \alpha_{15}\Delta r_{t-1} + \xi_{1t}$$

$$\xi_{1t} \sim N(0, \sigma^2)$$

The lagged difference terms capture the effects of the series, like for example, transportation costs, short-term changes in production and the financial sector, and other peculiarities of the economy of the island which affect

⁸ As only annual production data exists, an annual periodicity is used. If prices need to be forecasted monthly or quarterly, the utilized variable (parameter) can be replaced by any measure that is a good indicator of short-run economic activity.

prices in the short run. The model can also include the effects between the gap of real production and the potential production, which can be associated to a change in prices as a direct result of pressures over the installed capacity or to the differential between the level of unemployment and potential production (Kuttner, 1989; Galindo, 1997). That is to say, changes in the level of prices will have real effects, which can be transmitted through out several periods. In this case, consider the following model:

$$\Delta p_t = \alpha_{11}(p - p^*)_{t-1} + \alpha_{12}(y - y^*)_{t-1} + \alpha_{13}p_{t-1} + \alpha_{14}\Delta m_{t-1} + \alpha_{15}\Delta y_{t-1} + \alpha_{16}\Delta r_{t-1} + \mu_{1t} \quad (7)$$

The dynamics of inflation is modeled assuming that any increments in the monetary supply generate increments in the price level. Nevertheless, the presence of idle capacity leaves:

$$(p - p^*)_t = (v - v^*)_t + (y - y^*)_t \quad (8)$$

This equation indicates the deviations in the observed price level and that forecasted should be compensated with fluctuations in the velocity of money and the total production (Galindo, 1997). Inflation (gp_t) can be modeled under the assumption that it tends toward its equilibrium value and the growth rate of inflation (ggp_t) can be estimated in its simpler form (Galindo, 1997):

$$ggp_t = \phi_{ij}(p - p^*)_{t-1} \quad (9)$$

Equation (9) tells us that the rate of growth of inflation accelerates when $p^* > p$ and vice versa. In this case, the general form of the model of price gap can be solved:

$$ggp_t = \delta_{11}(p - p^*)_{t-1} + \sum_{i=1} \delta_{12}(i)\Delta ggp_{t-i-1} + \varphi_{1t} \quad (10)$$

This model can also be expressed in the equivalent form for inflation (Hallman, Porter and Small, 1991; Orphanides and Porter, 1998):

$$gp_t = \gamma_{11}(p - p^*)_{t-1} + \sum_{i=1} \gamma_{12}(i)\Delta gp_{t-i-1} + \sum_{i=1} \gamma_{13}(i)\Delta z_{t-i-1} + \zeta_{1t} \quad (11)$$

V. Empirical Evidence

The series are of annual frequency for the period 1964 to 1997. The variables used in the P* model are the consumer price index (li), the real production level (ly), the prime rate (lr) and the money supply (M1) of the US (lm). All variables are expressed as natural logs.

The tests of unitary roots in Table 1 indicate all variables show the same order of integration. The existence of similarity in the order of integration in the series demonstrates a stable relationship over time, which suggests stability is achieved in the long run (Novales, 1997; Bhargava, 1996).⁹ This result is important as it suggests the relevance of the price equation in the long-run (Rodríguez, 2002). So, the necessity arises of using series that co-integrate in order to obtain unbiased and consistent estimates that do not suffer from the problem of spurious correlation. As long

⁹ The determination of the order of integrability of a series is fundamental and not doing it correctly, in terms of political economy, can lead to erroneous conclusions in decision-making.

as co-integration exists among the variables, the relationship will not hold due to theoretical reasons rather than due to the magnitude of the variables.

In order to determine the existence of the long-run relationship among the variables, a model of autoregressive, unconstrained, lagged vectors is estimated. According to Table 2, the results indicate the presence of at least two vectors of co-integration. The existence of more than one vector of co-integration leads to the rejection of the test of weak exogeneity, as shown in Table 3. This suggests it is not possible to make valid statistical inferences using only one equation. This leads one to conclude there is a strong feedback between the level of economic activity and the price level.

One should note well the alpha values are close to zero which means that, in spite of weak exogeneity, the variables considered contain relevant information to explain the behavior of the system. By being so low, any exclusion of some of the variable would invalidate statistical inference and lose relevant information in subsequent estimations of the information generating process (Ericsson and Irons, 1994; Rodríguez, 2002). So, in rejecting the weak exogeneity hypothesis, one should include more than one co-integration vector for each equation in the error correction form (Ericsson and Irons, 1994; Rodríguez, 2002).

Table I
Order of integration of the series by means of the Dickey-Fuller (ADF) and Phillips-Perron (PP) tests

Variable	ADF	PP
p_t	-1.754	-1.055
Dp_t	-2.862*	-2.300*
m_t	-1.136	-0.878
Dm_t	-3.235*	-2.818*
y_t	-0.971	-1.475
Dy_t	-5.369*	-5.105*
R_t	-3.055	-2.088
DR_t	-5.553*	-3.928*

*Indicates 95 percent of significance

Table II
Cointegration tests for lp_t , ly_t , lm_t , lr_t

Eigenvalue	$H_0: \text{rank} = p$	$-T \ln(1 - \lambda_{p+1})^a$	95%
0.959	$p = 0$	105.87	15.00
0.707	$p \leq 1$	40.47	11.23
0.164	$p \leq 2$	5.91	7.37
0.018	$p \leq 3$	0.6	2.98

Eigenvalue	$H_0: \text{rank} = p$	$-T \sum \ln(1 - \lambda_{p+1})^b$	95%
0.959	$p = 0$	152.85**	36.58
0.707	$p \leq 1$	46.98*	21.58
0.164	$p \leq 2$	6.51	10.35
0.018	$p \leq 3$	0.6	2.98

a/ $-T \ln(1 - \lambda_{p+1}) =$ maximum characteristic root test;

b/ $-T \sum \ln(1 - \lambda_{p+1}) =$ trace test;

It doesn't include intercept neither tendency.

By normalizing the first cointegration vector of the model, the restated equation is:

$$li = -0.310 * ly + 1.037 * lm + 0.106 * lr \quad (12)$$

Maximum Likelihood Test: $\chi^2(2) = 11.98$

The signs are as expected in standard economic theory. The parameters indicate the relationships economic agents use to maintain the prices in the path toward equilibrium mean short-run price level dynamics can be interpreted in an error correction model.

Table III
Weak exogeneity tests for the price equation

r	DGF	$\chi^2(r)$	LP	LY	LM	LR
1	1	3.84	45.67	27.61	43.80	0.17
2	2	5.99	60.58	47.96	44.69	2.66
3	3	7.81	62.84	49.86	48.95	5.46

Table IV
Alpha Parameters for the price equation

	dlp _t	dIm _t	dly _t	dI _t
dlp _t	0.125	0.410	0.062	0.000
dly _t	0.073	0.048	0.040	0.000
dIm _t	0.150	0.012	-0.167	-0.000
dI _t	0.034	0.161	0.800	-0.001

The tests of strong exogeneity, summarized in Table V, indicate the presence of a feedback effect between the level of prices and economic activity. In other words, unexpected changes in the level of the economic activity are being directly transferred to the price level. The surprise effect in prices will affect the expectations of economic agents and, therefore, real production (Hoover, 1981).

Table V
Granger Causality Tests

Lag	lp _t → ly _t
1	2.822*
Lag	ly _t → lp _t
1	4.116*
Lag	lp _t → lr _t
1	0.003
Lag	lr _t → lp _t
1	13.569*

The results obtained mean that the generating process of information is an approximation to forecast inflation stemming from P*. The final model, presented in Table VI, does not have autocorrelation problems [LM $\chi^2(4)$: 9.880], heteroskedasticity [ARCH $\chi^2(2)$: 2.507] and the errors are normally distributed [JB $\chi^2(2)$: 0.341].

Table VI
Inflation Model

Dependent Variable: LI
Method: Seemingly Unrelated equations
Date: 04/09/02 Time: 08:47
Sample(adjusted): 1966 1997
Included observations: 32 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.535658	0.311386	1.720240	0.0973
ECO(-1)	-3.541897	0.905738	3.910509	0.0006
DI	0.286898	0.267726	1.071612	0.2937
DY	-11.04772	2.881736	-3.833704	0.0007
DM	-1.603489	2.045034	-0.784089	0.4401
DR	0.795845	0.462270	1.721604	0.0970
R-squared	0.583206	Mean dependent var		1.531061
Adj R-squared	0.503053	S.D. dependent var		0.501789
S.E. regression	0.353733	Akaike info criterion		0.926814
SSR	3.253309	Schwarz criterion		1.201639
Log likelihood	-8.829023	F-statistic		7.276183
Prob(F-stat)	0.000223			

VI. Conclusión

Analysis of the present and future evolution of prices in PR is essential for sound public policy. However, few studies have analyzed the evolution of the prices in PR in either the short or long run; the P* model offers a feasible framework to meet this need. According to the results obtained of the application, one may say that the price level in Puerto Rico is a monetary variable that is influenced by both the monetary policy of the United States and the economic activity of the island.

The VAR model captures the empirical regularities in the evolution of prices. Through the Johansen procedure, two co-integration vectors have been established and an estimate then made for the long-run equation of prices. The signs conform to that expected in standard economic theory and the statistical tests yielded satisfactory results. One concludes that the long-run evolution of the price level can be obtained by calculating the co-integration error of the MCE of the price level, which can then be used to estimate the future inflation of PR for local policy purposes.

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POLITICO-ECONOMIC TRANSITIONS: EVOLUTION AND GROWTH*

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Abstract

A theory that provides intuitive understanding of a process as complex as simultaneous political regime transition and growth in economic income would be a valuable addition to Political Science. In this paper, I attempt to provide such an explanation by employing simple insights from evolutionary game theory and developing their application to politico-economic transitions by borrowing freely from various other bodies of literature including economic growth, spatial voting models, and comparative politics. The result is a theoretical frame that comfortably deals with transition as a relatively smoother dynamic and provides some explanation for how regime transition might occur. It also provides an example of a learning strategy for politicians, which generates the credibility required for successful economic reform and a rationale for democratization.

* I would like to express my gratitude to James McHenry, James Lee Ray, Kenneth Shepsle and Richard Tucker for providing careful remarks on this paper, which is a part of my dissertation. I would also like to express my thanks to an anonymous referee at the ARPE for helpful comments. Any errors that may remain are solely my responsibility.

I. Background

Abstracting from a possible western bias or any disdainful connotation, it is perhaps instructive to see economic and political reform as evolution – from a less developed primitive stage of being to a more developed advanced stage of existence. Economic growth and the politics of regime transition then become the science of studying this evolutionary dynamic. There is little need to suggest the charisma of such a topic. Everyone has a horse in the race and excitement is high about who will make it and who will not. There are swashbuckling economic advisors, the meanest of ‘secondary property rights enforcers’, the slimiest of corrupt politicians, the most pitiable of the downtrodden, the most intrepid and the most opportunistic of entrepreneurs – the whole nine yards. Nevertheless, and perhaps even more than evolution from a biological perspective, while there is a strong feeling among many scholars that there is indeed a unifying method to the madness (that there is indeed sense in looking at a composite dual transition), an overarching integrated “theory of evolution” for economies and polities in transition eludes us. We have made progress through answering some difficult questions about many of the specifics, but we simply do not have enough understanding of the big picture to provide anything close to a single evolutionary theory of politico-economic transitions.

For this paper then, the following observations provide the impetus. It is now commonly acknowledged in the economic growth literature that convergence in economic income of all countries to the same high-income group of homogenous countries will not happen unconditionally no matter how much time we allow the

laggards to catch up.¹⁰ We know in addition that, *ceteris paribus*, we can expect two groups of countries to form in the limit – one high-income group and one low-income group – with any middle-income groups simply disappearing.

We also know from the economic development literature that economic growth is closely related to sensible and credible economic policy. It is an established truth – to the degree that major international institutions base their very existence on it – that certain policies cause dismal economic performance and yet others are correlated with better performance. There even seems to be some consensus that these policies are self-reinforcing and hence countries that adhere to one set of policies or the other are lumped together in the so-called vicious-cycle or virtuous-cycle. In this literature, an inordinate amount of emphasis is placed on credible commitments and much has been written about it. Credibility can be studied in numerous ways. If it is a public good that one can free ride off of and accumulate, then all the well-known problems of public-good provision are immediately relevant and we are in familiar territory. A point of interest here is that the accumulation of credibility is a process. The net result is interesting in that one might have credibility or no credibility with the concept of having some credibility becoming less relevant in the limit or in a steady-state equilibrium, where having no credibility is a Nash equilibrium in the transition game just like the low-income group or the vicious-cycle members.

What is more is that one can argue that having no credibility or belonging to a low-income group can be seen, *ceteris paribus*, as a stable evolutionary strategy –

¹⁰ Of course, another way of saying this is that we have some idea as to what some of the relevant variables might be for increasing a country's national income.

one more reason as to why nonconvergence is more likely to characterize the world than convergence. This characterization of credibility makes it a pivotal element of the story and links the political and the economic in a manner that reduces necessity of the term “dual transition”. The problem now is to be more explicit about where the credibility is coming from – providing a sort of credibility capital production function for the political sector of the unified economy in transition and consequently how it is being accumulated. Figure Two below is a simplified diagram of a possible solution to this crucial problem suggested in this paper.

More formally, I suggest here that the theory of evolutionary games is illustrative and I provide an example of an evolutionary game that produces the credibility I seek and conforms to a number of established facts about politico-economic transitions. In an evolutionary game, at the start of time, we would have in the world a homogenous group of ‘animals’ or phenotypes – countries in our case. A natural genetic function then determines the relative fitness of an animal defined quite simply as the rate of change in overall population representation of the animal group. In the case of countries and credibility in particular, we are interested in assessing learning strategies instead of the genetic function, which in effect provides for an estimation of relative fitness over time. This can be achieved by looking at the role of credibility capital in spatial voting models and the degree to which political entities like parties, which tend to exist across a variety of regime types, internalize it in their strategy of playing a political game.

The purpose of this project is to provide a causally connected theory between the mechanics of the political regime and the resulting economic income of a state and to therefore propose a logically consistent and valid causal explanation for the interplay between regime

change and economic growth in a kind of general equilibrium framework thus devising a unified theory for politico-economic transition in the process. To achieve this, I introduce evolutionary game theory. The reason for doing so is that it provides a very convenient and simple way of looking at the dynamics of the system and neatly incorporates the political processes we are interested in with the economic outcomes that are observed.

The structure of this paper is as follows. First, I discuss briefly the key elements that I use for the purpose of this paper and suggest their relevance in the unified theory I intend to present. More comprehensive reviews of much of what I outline already exist and thus the discussion here is kept minimal. Second, I elaborate on the theory of transitions that I favor and suggest its implications. Finally, I conclude with some observations and remarks about possibilities for further research.

2. Preliminary Discussion

2.1 On Economic Growth and Development

In the economic growth literature, in a series of articles, Quah (1993, 1994, 1996) and Bernard and Durlauf (1995) among others have suggested fairly recently that, in per capita income, countries do not all necessarily converge to a point (actually, to be exact, a stochastic steady-state) at some eventual time in the future like many before them had argued (see Solow (1956), Mankiw, Romer and Weil (1992), and the idea of unconditional convergence by Barro (1991, 1999), Barro and Sala-i-Martin (1992, 1999) and Sala-i-Martin (1996)). Instead, they might form clubs of convergence. In fact, to be exact, just two clubs – a club of high-income countries and a club of low-income countries with any middle-income groups simply vanishing over time as the system approaches steady state. While there

is convergence within those clubs the system on the other hand is characterized by divergence. As to exactly what causes this surprising outcome is not entirely resolved in the economic growth literature and remains somewhat of a puzzle.

Separately in the development economics literature, Rodrik (1989, 1992), Calvo (1989), Dornbusch (1990, 1993), Garrett (1998) and Dixit (1992, 1993) among others have suggested that countries undergoing economic reform (without much attention to regime¹¹) face a polarized outcome too. Unreformed countries form one group and reformed ones form the other. Those countries that are reforming must credibly suggest their sincerity to the domestic private sector and foreign investors in order to successfully jump from one group to the other. If reform is seen as fleeting or 'incredible' then distorted incentives will cause capital flight, mobile capital investment (which is less complementary with long-run growth), intertemporal substitution in consumption and so on which is likely to hinder the progress of reform. The credible commitments idea then gives us the virtuous vs. vicious cycle theory.

It is easy to see that these two strands of literature are obviously closely related. Simply, the idea is that virtuous cycles are virtuous for the reason that they reinforce economic reform, which eventually leads to higher growth; it takes no far stretch of the imagination to see that these countries are liable to be the ones that form the high-income convergence club. Likewise, the low-income convergence club is composed of the countries facing a vicious cycle of pathetic reinforcing economic performance, which in steady state should be a stable group if the cost of reform outweighs those elusive benefits accrued even in the slightly longer run

¹¹ Although Rodrik grants that democracy can be seen as a meta-institution for economic growth.

that initially tend to be a significant component of the lure towards reform.

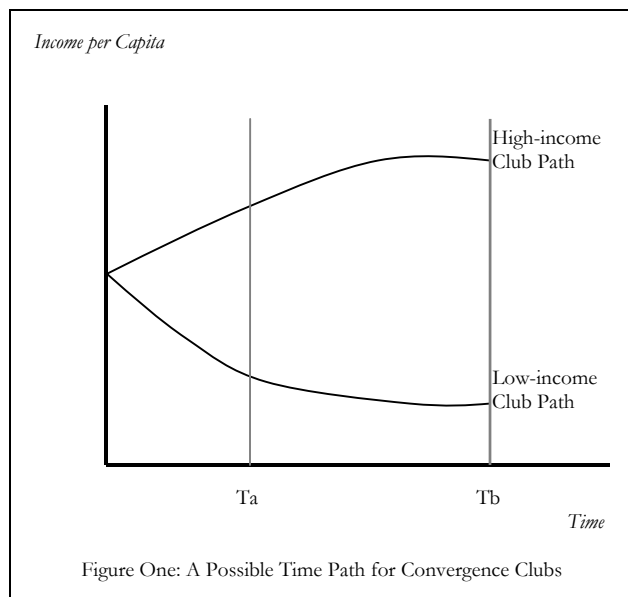
2.2 On the Political Front

In comparative political science, Przeworski and Limongi (1993, 1997) and Leblang (1997) have reminded us - reflecting the frustration of the field - that while we know political institutions matter for growth in some broad almost ineffable sense, we are in no position to suggest that specific political regimes matter other than that we have a strong hunch that democracy matters. This is a dismal state of affairs and not much has changed since the late 1990s. Geddes came to the same conclusion in a 1999 Annual Review of Political Science piece, as did Heo and Tan, the authors of an article published in 2001.

This begs the obvious question - Why do political institutions matter? Consider one simple explanation for why institutions matter for economic growth. To start with, I hope most will agree, following Douglass North's seminal work, that they suffer - or benefit, depending on what their position on the root scale economies curve would suggest - from path dependence. That this path dependence then, in the limit, would create a tendency to reinforce a virtuous or a vicious cycle is also probably not that contentious a claim to make. In fact, it would then actually indicate why steady states of convergence clubs might be 'steady' in the sense that one would not expect their composition to be changed by club members extricating themselves from one club and joining another. The costs of such a change, which even if bounded, become prohibitively high as the club approaches steady state precisely because of path dependency, and can therefore be seen as a situation of transaction costs (of institutional change) superseding benefits.

This would provide a foundation of an explanation for why democracy might matter for economic growth if democratic institutions systematically produce 'virtuous path dependence'. What is more is that the economic convergence story can be modified by a cost function rooted in political institutional embeddedness (which need to be endogenous to the model) that maps out the probability of a successful transition depending on temporal distance from the steady state outcome within the respective club compared to the position of the other club along a similar dynamic.

In figure one, it is obviously more likely for a successful transition to occur at time T_a than at time T_b . A formal model based on the story I have provided thus far on political institutions engendering credible commitments (or accumulated credibility capital) that then generates virtuous-cycle or vicious-cycle path dependence and finally convergence clubs will, in my opinion, be a huge step forward in our understanding of transitions.



So far so good, but here is where things get murkier. Geddes reminds us that any relation of regime type (specifically democracy) to growth evades us. Superficially, if we allow that path dependence exists in institutions, then, if we can knit a story about the relative type and relative proportion of political institutions that characterize a democracy of quality x , say on a scale from 1 to 10, as opposed to another regime, then we can fiddle with the amount and direction of path dependence to suggest where convergence through virtuous cycles is coming from. Alas, our task is more complicated. Pierson (2000) recently advised us on using the term path dependence carefully lest we might fall prey to the monster of conceptual stretching who smiles beamingly upon political science. In similar vein, in a recent article Alexander (2001) too throws a spanner in the works by suggesting that democratic institutions do not embody

anything special that provides them with extra path dependence in the first place. Economic institutions that deal with property rights are more susceptible to path dependence he argues than are democratic institutions.

There is some merit in this argument. Some very astute political scientists from the American politics tradition have argued why this might be the case.¹² Shepsle and Weingast (1984a) argued that public sector institutions should be evaluated on the basis of self-interested actors facilitating evaluation of public-sector institutions like their private-sector counterparts. McKelvey and Ordeshook (1984) then support the suggestion that when rules engender political constraints that lead to results that are not to the liking of politicians, they (political groups) are able to bypass such constraints. They are unable however to support a stronger version of the hypothesis that institutions are therefore subservient to political actors to the extent that they can permit certain equilibria not to obtain in spite of original institutional design and of course this is what Alexander is worried about. To this, Shepsle and Weingast (1984b) answer that rules have consequences and therefore politicians are indeed interested in them in accordance with their preferences. They believe that the first hypothesis is necessary and the second fails because a sufficient condition is not met – that of Coasian transactions costs. If these are incorporated, then we find that certain institutionalized procedures are more susceptible to manipulation by motivated politicians than others.

Note here that Shepsle and Weingast's assertion serves to only bolster our position that costs increase as transitions approach steady states since transaction

¹² Though public choice theorists like Niskanen (rent-seeking bureau), Brennan and Buchanan (private contract-enforcing rents), and so on have long recognized this.

costs approach a level high enough to dissuade more and more efforts at institutional change and in fact provides good grounding for modeling the institutional path dependence dynamic. The link, however, between these transaction costs with an explicit political process has yet not been provided and without that link all we have is a rather good story for divergent outcomes. I will return to this point below and indeed this is a motivation for this paper. First, however, I make some finer points in the story clear.

2.3 On Hope and Doom

We are arguing that from an economic convergence (to convergence clubs) standpoint the situation progresses towards one where extrication becomes prohibitively expensive. This can be construed as a doom story for it provides reason for why divergent outcomes are stable (and the 'steady-state' terminology does nothing to dispel the impression). The confusion comes from the fact that we are looking at *ceteris paribus* conditions or a situation of unconditional convergence where the state's behavior does not diverge wildly from the past. This is a very important point. Transaction costs will probably take care of slight deviations in behavior for instance a politician that is slightly more interested in leaving a legacy compared to exploiting his office than his predecessors or an autocrat in a particularly good mood. Wild deviations, like an autocrat dying and a strong reformist backbencher suddenly rising to power or a severe economic shock creating adverse terms of trade causing a drying up of reserves and a subsequent financial crisis allowing the IMF to come thundering through the front door, dramatically change the conditions and may indeed force the country on to a credible virtuous cycle and therefore convergence to the high income club. So,

simply, what we are not suggesting is that such economies desperately seek to extricate themselves and are nevertheless hapless.

A punctuated equilibrium process might well be at work here where institutional redesigning (through shock therapy, gradualism or whatever) disturbs the country's path to steady state and consequently the relative cost of extrication from the group. Then, within the tatonnement process of the punctuated equilibrium time period – where equilibrium is defined simply as the adjustment to a path to either one of the convergence clubs – incentives of relevant actors are significantly altered. This then is an opportunity for change since, in equilibrium, individuals should be attracted to the institutions that best serve their needs. Talent is reallocated efficiently in equilibrium and utility is maximized. If we allow that the reallocation of talent is vital to furthering marginal political reform and consequently economic growth then extrication from the vicious-cycle group becomes more possible. This is a vital component of an explanation for how stubborn path dependency can be overcome.

2.4 On Parties and Political Regime

Thus far the emphasis has been on explaining economic outcomes using the concept of path dependence in political institutions, albeit in a manner I think provides more meaning to the political sector in equilibrium analysis than the extant literature in comparative political science achieves. However, it does little to incorporate regime-type variables. This, as I will argue more comprehensively below, can be done by exploiting the parallel literature in political science on convergence to the median voter's bliss point or preferred position in an issue space.

The first principles of political convergence are simple. In a Downsian spatial voting model with two parties, single-peaked preferences and perfect information both parties converge to the median voter's bliss point through iterated reaction function competition in a tatonnement process. What happens when information is incomplete or parties have policy preferences that differ from each others' and from the median voter's bliss-point defined platform? What happens when electoral rules differ? Alesina and Rosenthal (1995) provide a good basic analysis. They show that we can get policy divergence. The analysis gets infinitely more complicated with more than two parties and issue cleavages based on orthogonality principles. Some very recent advances are being made in this field that provide predictions about the degree of divergence. What is material here however is that a useful parallel to convergence clubs exists in this literature and is even more nuanced than the simple high-income/low-income convergence clubs that the economic growth literature offers. I directly exploit this in my discussion below and it forms the basis of my argument as summarized in Figure Two.

For instance, Person and Tabellini (2000), building on some high-quality work by Myerson (1993), Ferejohn (1986) and Lizeri and Persico (2001), argue convincingly that PR regimes and large district sizes are theoretically characterized by more rent seeking, larger government sizes and more broad-based public goods than are presidential regimes and smaller district sizes. Likewise voting among party lists in PR and small district magnitudes with high barriers to entry attracts low talent (due to the possibility of free riding) and could consequently engender lower economic growth. (See Murphy et. al., 1993 for instance.) So does institutional redesign with PR and small district magnitude necessarily doom the punctuated equilibrium to the low-

income convergence-club steady state path? Obviously, as McKelvey and Ordeshook remind us, these neat and simple predictions need to be tempered by the incentives of the relevant actors within the matrix of political institutions they are operating in and the marginal changes they are able to effect to it. I hope that at least some will be convinced that an evolutionary game-theoretic approach, like the one I outline below, provides such a theoretical frame rather neatly.

For the purpose of illustration, one such important political institution can be considered – parties. The reason I select parties are several. First, they are institutions that face substantial potential for path dependency emanating at the very least from the stability of partisan identification over time (see Lipset and Rokkan 1967; Green and Palmquist 1990, 1994; Mair 1993) but also due to more proactive marginal changes that endogenize partisan identification. After all, why is it that advanced countries have higher partisan identification than developing ones? Mobilization theory – whether cleavage-based or cognitive – is glaring evidence of this, and is, broadly, a concept of crucial significance in a theory of politico-economic transitions. The cognitive mobilization literature (Zaller, 1994 for instance) makes the claim that parties are able to influence voter preferences by effectively broadcasting the party message. The problem therefore with Converse's (1966) learning model to some degree is that it assumes only reactive political institutions. Second, parties are political institutions with a more direct connection between the private sector and the public sector and necessarily operate at an intersection of the two. Formally, the literature (like Ferejohn and Noll, 1978 and Calvert, 1985) looks at the party's expected utility from a policy position as an additive probability function of the value it ascribes to its own policy platform and that of the opponent. If one assumes that the allocation of

talent across sectors is important for economic growth and political institutional transformation, then this necessitates looking at both sectors anyway. Third, parties exist across political regimes and therefore concentrating on them and not the regime itself saves us from being included in the Hall of Shame type list that Przeworski and Limongi drew up containing research endeavors attempting to provide a causal connection between political regime and growth by sorting on regime type variables. Parties almost always exist in democratic regimes barring some exceptions Anckar and Anckar (2000) mention in their engaging *Comparative Political Studies* article. Even in non-democratic regimes they appear to be permanent fixtures - like the National Unity Party of Burma, Zhong Guo Gong Chan Dang of China, CPSU during the Soviet Union, Niyazov's Democratic Party of Turkmenistan and the Democratic Front for the Reunification of the Fatherland in North Korea.

Before I continue with this example using parties, it is instructive to ask the following question - How is political convergence to the median voter (or divergence to party-defined bliss points) as I outline above related to convergence in economic growth within convergence clubs and divergence in the global system? One simple answer lies in the theory of credible commitments. On the economic front, we know that credible commitments by governments (to economic reforms at the least) have immediate and serious repercussions on economic growth. On the political front, the task then is to explore where credibility (accountability being a key manifestation) originates from and how it can be developed by political microfoundations.

2.5 On the Theory of Evolution

John Aldrich (1995) has conveniently answered the question for me about the relevance of parties. Although he obviously does not suggest any real explanation for why parties might be relevant in making a connection between the credible commitments argument and economic growth, he does provide three extremely strong reasons for why they are important. The three reasons that Aldrich suggests why parties exist are, first, to solve an Arrowian-type social choice problem, second, to overcome a collective-action dilemma in providing public goods and finally, third, to provide solution to the ambitious politician's problem of satisfying career-politics needs. These reasons are the final piece of the puzzle we need to knit together the whole story thus far provided into a unified theory on politico-economic transition.

Let us start from the observation that divergence from the median voter's preferred outcome is obtained (like Alesina and Rosenthal argue for instance) if there exists value for the party in making credible commitments to party-defined bliss points different from that of the median voter, say, to reward party loyalty. The dilemma is then obvious if party politicians should make credible commitments, which is – assuming certain regularity conditions hold - reconciling convergence to the median voter (and its social welfare maximizing attributes) with the value inherent in divergent outcomes (i.e. rewarding politicians that make credible commitments).

It is useful to bear in mind for this discussion that there are, as Przeworski and Limongi have noted before, two distinct median voters - one relevant for the political game and one for the economic. And that there is an incompatibility between market based 'voting' done by economic agents using the resources they own to derive their 'weights' compared to state-backed voting by

citizens where weights are likely much different (and theoretically more equal). The median voter therefore for 'capitalist' or market-based transactions is not the same as the one in a 'democratic' universal suffrage political regime.

What is interesting however is that a "theory of evolution" for political groups like parties can be created that reconciles these two median voters within the same game and in the process also rewards the divergent outcomes that produce credible commitments. Parties induce public spiritedness among their followers (a process some have dubbed creating a "warm-glow effect" in explaining why people vote and also in location theory) by providing broad-based public goods. The public nature of these goods causes parametric shifts towards the median voter from both sides albeit possibly at different rates depending on a number of factors.¹³

For example from Perrson and Tabellini's work one can argue that plurality rule and small district size produces this faster than large districts and PR. We can however preclude the inevitable homogenization by a single group this process will suggest (in the style of a non-democratic single-party regime on a virtuous cycle) by introducing diminishing marginal utility to the public good it provides. This prevents a natural (though obviously not an "imposed") extinction of other parties. The process uses Buchanan's optimal group size theory to allow other groups to capitalize on the opportunity as well

¹³ The type of public good is of course of obvious importance in the analysis. Schultz (1996), for example, discusses a situation of two parties attempting to provide public goods that may or may not be desired to the same extent by the electorate. Using a model of Bayesian updating along the equilibrium path, he suggests that non-revealing equilibria (concerning true costs) result when there are parties with polarized preferences and revealing-equilibria obtain when at least one party's preferences coincide with the median voter's.

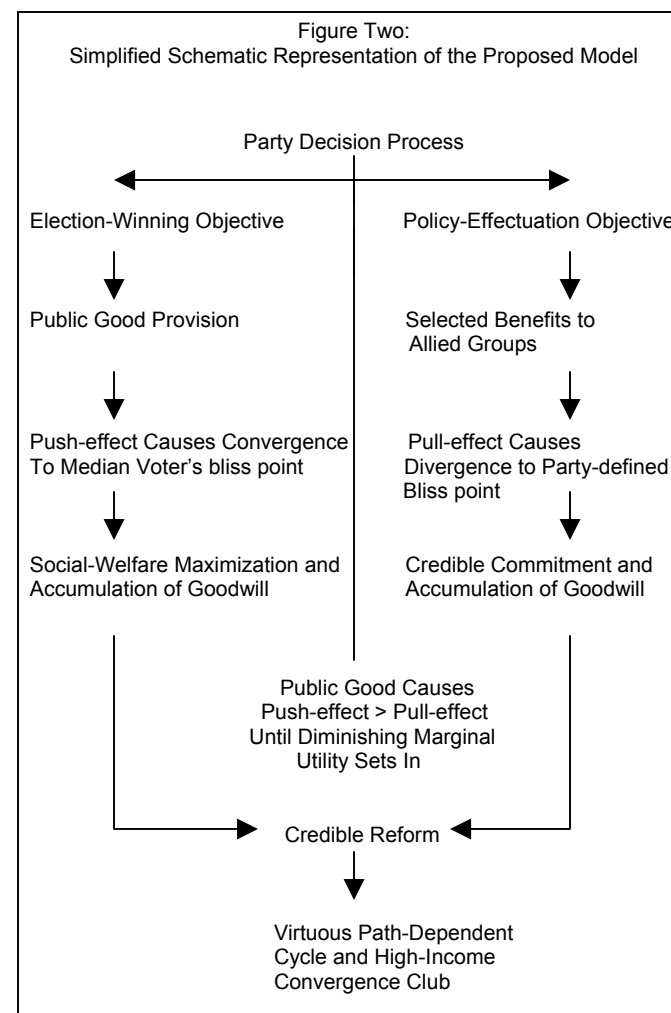
provided their public good package is of a different more desirable type. We can also allow this package to differ, and consequently enable an expansion of the optimal group size, by allowing provision of specific selective incentives to identifiable allied interest groups (subsidies, transfers, pollution licenses, etc.).¹⁴ This allows the group to delay the point of inflexion on its aggregate provided utility surface and these special interests become important to this extent.¹⁵ The schematic in Figure Two below summarizes this example where a party seeks to win an election as well as effect a policy desired by an allied interest group. It achieves both goals by providing a package of generally desirable public goods and selected benefits only for its affiliated interest group. The public and non-partisan nature of public goods engenders a general push towards the median voter for

¹⁴ It is illustrative to note Acemoglu and Robinson (2001) suggest political transitions and the subsequent stability of the regime depends crucially on the degree of asset equality among the electorate. Through their emphasis on mass revolution and elite reaction, they find consolidated democracies have more asset equality, which causes fiscal stability, and less incentive for a dissatisfied electorate to tip the boat.

¹⁵ It is interesting that McFaul (2001) asserts that party development depends more proximately on the institutional choices made by relevant political players. He also notes in conjunction with party development in Russia that the party system in Russia is yet not in equilibrium and a more stable party system may develop provided some institutional changes are made. The theory I provide here explains his suggestions rather well. Institutional choices would determine the rates of convergence to the median voter by the political group and also the degree to which it can make selective incentives to allied interest groups. It is no surprise then that political agents should be interested in the specific institutions chosen during transition so that they have more direct control over the degree to which rates of convergence can be manipulated.

the entire electorate while the private nature of selected benefits pulls allegiance back towards the party's preferred position. The effective execution of this strategy allows the party to accumulate a stock of credibility - through both public and partisan channels - thereby facilitating successful economic reform by being seen as credible. The probabilistic association of non-democracies with low income in this setup is clearly a result of a slower generation of credibility capital by the political elite as one of the channels of accumulating credibility (i.e. the election-winning objective) being effectively truncated.

This process also provides a tractable understanding for the endogenization of the median voter position itself like mobilization theory suggests. Although it is perhaps overly simplified - as will be explained below in our treatment of the learning strategies provided to us in spatial voting models - we have now a unified explanation couched in social choice theory that employs public good provision by political parties to provide an explanation for credible commitments and convergence to the median voter's bliss point in stochastic steady state.



3. Modeling the Dynamic

In order to look at these elements of the story as a cohesive evolutionary theory of transition some terminology of evolutionary game theory can now be introduced. As suggested at the beginning of this paper, at the start of time in an evolutionary game, we have a world of a homogenous group of 'animals' or phenotypes. Natural genetics then determine the relative fitness of an animal defined quite simply as the rate of change in overall population representation of the animal group. The "final" distribution of animals provides us with the evolutionary stable strategy or strategies (known as the ESS) with all other possible strategies getting systematically eliminated.

Evolutionary game theory is most interesting in a game theoretic setting and provides intuitive understanding of strategic behavior in repeated-play games. Of particular interest to us in this paper is the polarized economic performance of countries and not so much interaction between countries. Specifically, in steady state, *ceteris paribus*, memberships in high-income and low-income clubs appear to be the two unique evolutionary stable strategies.¹⁶ What is therefore of material relevance to us here is the genetic encoding as it were that determines this outcome. Obviously, there is little merit in talking about genetics with countries apart from perhaps issues such as resource curses and maybe even absolute size and location of territory. In the age-old nature versus nurture debate, we prescribe to the nurture thesis, which is why we must take refuge in the *ceteris paribus* condition when talking about the

¹⁶ This is precisely what Quah's Markov Chain Quartile transitions experiment attempts to demonstrate as it studies what the distribution of countries looks like over a long period of time.

process of convergence and the membership of convergence clubs. Therefore, instead of genetics we are interested in rational learning strategies instead, which, in turn, we believe must be intuitive and sophisticated at once. Any learning strategy that leads to low-income club membership for the country and pathetic economic performance should be just as rational as another that leads to high-income club membership and fantastic economic performance.

3.1 An Example of an Evolutionary Game

To understand better how evolutionary game theory logic can be applied to the kind of problem we are interested in here, consider the game shown in Figure Three below. The two players, politicians and the populations they represent, as collective entities, can choose to either undertake or support economic and political reforms or not to reform at all. Let the sum of the payoffs they consequently receive determine the nation's income. The two pure Nash equilibria of this game are of course (Reform, Reform) and (No Reform, No Reform).

Figure Three: An Evolutionary Game

POPULATION	POLITICIANS	
	<i>Reform</i>	<i>No Reform</i>
<i>Reform</i>	10,10	5,9
<i>No Reform</i>	4,6	6,12

When no reform is taking place the politicians are able to benefit disproportionately perhaps through inefficiently designed property rights leading to corruption and other forms of intervention in private sector activity. If, from this equilibrium, either player "mutates" and chooses to reform and the other does not concur then that player

loses more than the other does. Only when both players want reform can reform occur successfully. Obviously this sort of game is, very generally, a common framework we come across with in political science.¹⁷

From an evolutionary perspective the resistances of the equilibria of this game are important in considering its stability. Specifically, the resistance of (Reform, Reform) against (No Reform, No Reform) is 3/5 and the resistance of (No Reform, No Reform) over (Reform, Reform) is 2/5. What this means is that unless more than a two-fifths or forty percent of the total respective populations of the players want to reform, the country will be stable at the unreformed outcome. Similarly at least three-fifths of the reformers must want to reverse reforms for the equilibria to switch to the “inferior” outcome, evaluated so of course in normative terms and not strict Pareto criteria. Although it need not always be so, in this game the superior outcome is also the risk dominant outcome. It has been shown that the long-run equilibrium of such a game tends to coincide with the risk-dominant equilibrium due primarily to a specification of the process of mutation, which, in turn, can be significant over longer periods. (Kandori, Mailath, et. al. 1993)

3.2 On the role of Mobilization

Lipset (1959) has famously argued that democratic tolerance norms are required for democracy and that a reciprocal relationship that fosters free participation is vital. Huber, Rueschemeyer, and Stephens (1993) reaffirm its importance and suggest a more nuanced

¹⁷ A long line of literature talks about such a negotiated transition game. Some of the most notable are perhaps Rustow (1970), Przeworski (1991), Casper and Taylor (1996) and the concept of a focal point in Weingast (1997)

analysis based on the role of the state, the impact of transnational entities, but most importantly relative class power, which directly dictates the degree of political participation. Shin (1994) masterfully reviews the extensive literature and also suggests that commitment to democracy is one of the most crucial components for successful democratization. There is then little debate then over the relevance of committed political participation for democratization and thus any politico-economic transition theory should include it in a clear manner. An evolutionary game-theoretic approach, even as simple as the example provided above, can do so through emphasis on the thresholds that the resistance criterion suggests. Resistances provide parsimonious and intuitive understanding for why participation is crucial, why democratizers need to mobilize, and why its resisters need to be cautious of the size of their opponents. What such an approach also does is incorporate a separate observation made most recently by Przeworski, Alvarez, et. al. (2000) that authoritarian regimes have a higher population growth rate than do democracies and thus lower per capita income. In my view, their most convincing explanation of this fact is borrowed from Becker, Murphy and Tamura (1990) who suggest that in countries with higher human-capital acquiring resources, it makes sense to invest more resources into fewer children and emphasize quality over quantity since human capital is accumulated with increasing returns.¹⁸ A theoretical framework that lends some intuitive understanding as to why demographics are important in politico-economic transitions simply

¹⁸ Note that their puzzling over democratization and economic development continues since this explanation uses and does not explain their carefully formulated observation that the occurrence of democracies is correlated with higher economic income.

does not exist and an evolutionary game-theoretic approach once again appears to be a constructive avenue. Threshold maintenance (or increasing the resistance of a Nash equilibrium) can happen either by increasing the population or by thwarting participation. If participation increases (in a positive way if it is democratic or in a negative way if it is exclusionary and to the benefit of a select few like in an oligarchy) the only way the current outcome can remain with a higher or equal resistance is if the opposing class of players increases its numbers. Here obviously a new debate emerges. What is more effective – increasing the group's numbers or its efficacy? In a highly repressive authoritarian regime this point may not be debatable since efficacy can be kept in check. Hence, Przeworski's and his coauthors' result would obtain. But it can also obtain through other sources and hence the fertility literature, income inequality literature and mobilization literature are all relevant in sorting out the exact causal mechanism. The unifying theoretical frame however is this hidden calculus of group fitness – a “hidden calculus” perhaps like the famous pool shark who “knows” how to solve complex physics and geometrical problems without really knowing how to.

This sort of analysis lends some additional theoretical grounding to the top-down and bottom-up approaches to democratization efforts that have emphasized either the role of mobilization of democratizers and demobilization of anti-democratic movements or both. Mobilizing, by its tradition in collective effort games, seeks a critical threshold or, as the n-person coordination games describe it, a tipping point. The concept of resistance of Nash-equilibria in a game like the one depicted above, in my view, provides an intuitive understanding for what is really happening underneath it all. A major problem with this approach is that it analyzes a single game – that of democratization or that of economic reform. If we are

interested in looking at a learning strategy that specifies how changes or mutations are produced over time, it is perhaps more constructive to analyze a series of nested games for they would give us richer understanding for why a given amount of mutations occur. Here again the democratization literature in political science is of immediate relevance for it suggests what exactly these nested games might be. We feel that it would be erroneous to simply look at the distichous process of the largest and substantively most significant game when the mutations carry us over the critical threshold as it were.

3.3 On the Learning Strategy

A possible learning strategy, one that we are proposing here, relates primarily to the behavior of politicians and the political institutions they belong to, but directly incorporates the effects of their electors or, more generally, their supporters. This is done by marrying the theory of clubs and the multidimensional spatial voting model – the former provides a measure for how political entities interact with their environment and consequently how they change with it while the latter links political entities with their supporters in a dynamic setting using the basic principles of political competition. Together they provide an explanation for how the evolutionary process might work. A brief discussion of this link follows.

Buchanan's (1965) theory of clubs pertains to groups that provide a semi-public good. This is an impure public good that, though excludable, is non-rival only a certain extent beyond which sharing it decreases utility to the existing group members. As a matter of fact, marginal utility to existing members of an additional member to that point increases at a decreasing rate. Obviously this neatly determines the optimal size of the group. One

such semi-public good might be the brand name or credibility capital as it were of the group. In political groups such as parties, we can assume that participation in the group is at least valuable for this reason alone to politicians. What is instructive here is that the concavity of the relationship posited – due perhaps in this context to diseconomies of scale setting in through membership – engenders a need for a membership rule. The organization structure of the group (or its “hierarchy”) accomplishes this by providing legitimate roles for members and effectively curtailing illegitimate membership. It is thus not surprising that admission to the hierarchy of a political group such as a party is often based on a sort of voting system irrespective of the regime it operates within. Of course we do not dispute that the nature of candidate selection in Zhong Guo Gong Chan Dang of China is less “democratic” than it is in the Social Democratic Party of Germany, but of material relevance to us that it is “democratic”.

This facilitates analysis of transitions of political groups (and by extension of the economy and polity) using a similar underlying logic as was outlined in the section above titled *On the Theory of Evolution* and summarized in Figure Two. The logic introduced there can be restated in more general terms by introducing the more formal language of multidimensional spatial voting models.

In the spatial voting model literature, the geometric concept of a yolk pertains to the circle of minimum radius that intersects all median hyperplanes of ideal points distributed in the issue space. For our purpose here it can therefore be understood as simply a measure for the degree to which the electoral system possesses the ability to generate outcomes different from what the median voter would desire – the smaller the yolk the lesser the chance of an undesirable result being obtained. What is important is not the dispersion of ideal

points that generates the yolk, for, depending on the configuration of ideal points, even more dispersed ideal points can produce a smaller yolk. (Miller, et. al. 1989) Instead, once we grant the assumption common in much of the literature that politicians want to stay in power and political groups wish to perpetuate themselves, it is the number of ideal points represented that becomes important, and in this manner the idea of mobilization remains crucial in the learning strategy being suggested.

This assumption is also crucial to the development of the concept of a finagle point with minimum finagle radius – a point on the issue space, which when chosen by a politician enables her to beat any competitor by changing her position to a new point that beats the competitor without hurting her credibility with her supporters. Using the construct of a finagle circle, situated within the yolk, with a minimum finagle radius much smaller than that of the yolk itself, Wuffle et. al. (1989) show that as the number of voters increases, the finagle radius becomes increasingly smaller than the radius of the yolk.

This provides the foundations of a rather sophisticated learning strategy for politicians that has in it a number of ingredients identified as being important in analyses of regime dynamics. A fuller development of this or other, perhaps better, learning strategies is however necessarily subject for future research. Some remarks are nevertheless in order. Economic reform enables higher growth. Reforms however do not work unless they are credible. Where then does credibility come from? If politicians want to stay in power, they cannot change positions indiscriminately and this automatically lends them credibility through the channels suggested in Figure Two. This is the fundamental defense that politics has from protecting itself from chaos (in the style the global-cycling theorem might suggest). Credibility is the constraint, but the maximand is the political objective,

whether we analyze parties in general or the individual politician in particular. The essentials remain unchanged. The politician's objective of winning an election yields a learning strategy - to locate himself in a position like the finagle circle with minimum finagle radius that is defensible from an attack by a competitor with minimum loss of credibility with his supporters. The credibility capital that he consequently obtains allows his party to employ this accumulated credibility towards its own brand name to effect economic reform with more success. The learning strategy presented here simply provides the workings for Figure Two at the level of an individual politician rather than the party he or she belongs to and is therefore more general in nature.

4. Concluding Remarks

As most politico-economic transition theorists would probably attest, a theory that provides intuitive understanding of a process as complex as simultaneous political regime transition and growth in economic income would be a valuable addition to political science. In this paper, I have attempted to provide such an explanation by employing evolutionary game theory and developing its application to politico-economic transitions by borrowing freely from various bodies of literature including observations on convergence from economic growth, contributions in the spatial voting model literature that employ geometric analysis and the literature on development and democratization in comparative politics. The result is a theoretical frame that comfortably deals with transition as a relatively smoother dynamic process and provides some explanation for how regime transition might occur. It also provides an example of a learning strategy for politicians, which generates the credibility required for successful economic reform (and subsequent higher

growth) and a rationale for democratization. However, the analysis is necessarily incomplete and a fuller analysis, though essentially warranted, would require more space than I have. One natural extension of this analysis would be its application across more distinct political systems by devising underlying learning strategies similar in nature to Tsebelis's (1995) institutional veto players, which in turn agrees rather well with the analysis in this paper.

I end with the hope that transition theorists will employ evolutionary game theory in their work for the flexibility and simplicity it provides towards building of a more systematic and cumulative research enterprise for the study of politico-economic transitions in political science.

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AND, INJUSTICE FOR SOME: CORRUPT EXCHANGE AND THE RISK-AVERSE OFFICIAL

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Abstract

Although corruption and optimal law enforcement literature have addressed the effects of corruption, little has been done to analyze the decision to become corrupt. For example, little is known about risk-preferences and how they might affect the nature of a corrupt exchange scheme. To answer this question, a theoretical analysis is developed that considers the non-coercive incentives and circumstances necessary for a law enforcement official, assumed averse to criminal risk, to choose a corrupt exchange with organized crime that involves murder. Risk-aversion and the severity of the crime involved are shown to reduce the likelihood of detecting the corruption scheme and murder is shown to be optimal. Corruption schemes involving less risk-averse offenders are analyzed and compared.

JEL Code: K42

Key Words: Corrupt Exchange, Risk-Aversion, Decision Modeling, Organized Crime, Detection

I. Introduction

Porta and Vannucci (1999) model corruption and corrupt exchange within the context of a market for political rents. The benefit-side of a corrupt exchange is considered. Rose-Ackerman (1999) views corruption as

an outgrowth of incentive systems and monopoly interests. An institutional context is developed within which opportunities for corrupt exchange exist. Bac (1998) analyzes corruption within the institutional structure of public organizations and indicates how supervision, supervisor procedures, penalties and bribes, and organized corruption are interrelated. Circumstances that affect the corruption choices of a “street-level” bureaucrat are considered. Wells (2003) indicates that accountants, when suspecting corruption, can seek observable indicators of corruption schemes such as bribery and kickbacks, economic extortion, conflicts of interest, and illegal gratuities. Individual motives to corruption suggest greed and specific processes and roles. Behavioral clues that may suggest the presence of corruption are discussed. Optimal law enforcement literature such as Polinsky, et. al. (2001) indicates the interrelationship between deterrence and the effects of corruption that include extortion, framing, and risk bearing.

These analyses leave the question of how risk-preferences are related to types of corruption and crime unanswered. Moreover, these analyses consider relatively common forms of corruption and corrupt exchanges that do not involve more severe forms of crime such as murder. The effects of different preferences for criminal risk are not examined. By default, corrupt decision makers may be assumed risk-neutral. The purpose of this analysis is to examine the relationship between the decision to become corrupt, the severity of criminal acts that might be involved, the corresponding risk preferences, and the related crime characteristics.

A. Criminal Success and Risk-Preference

Psychologists and economists (Rietz, et. al., 1998) consider sensation and risk seeking behaviors to generally mean the same thing and that, for a given individual, they are stable. To gamble for criminal gains, risk seekers (who are assumed rational) require only that their odds for success lie somewhere between zero and those of a fair gamble. In other words, the inducement to a criminal gamble requires an odds threshold that is less than a fair gamble. As risk-seeking gamblers, such offenders will more often lose and encounter police and the criminal justice system. Therefore, risk-seeking criminal offenders are over represented among the incarcerated. Criminal justice officials who believe that the incarcerated represent an unbiased sample of the criminal population may assert that criminals appear to prefer risk.

Experiments with rats such as Battalio, et. al. (1985) find a tendency toward risk aversion toward food pellets. Given that risk aversion is a survival characteristic of rats, the most successful individuals and criminal offenders may also be those who avoid risk. Property owners, for example, avoid the risk of their house burning down by transferring that risk to an insurance company. Successful criminal offenders may also be those who avoid the risk of crime. Crime benefits and criminal risk can be avoided by buying "crime insurance." Crime insurance transfers the risk of crime to professional criminals who assume the risk of committing a crime. The offender who is averse to the risk of crime can safely gain the benefits from crime. The price of crime insurance is that the risk-avoiding offender must pay by doing something that benefits the professional criminals who committed the crime. This is a form of "corrupt exchange."

B. Corrupt Exchange, Risk-Preference, and Crime Severity

Individuals seeking to benefit from serious crimes are able to transfer the risk of committing a crime to other professional offenders with different degrees of success. Robert Becker (2000) indicates that an acceptable bet for risk averse individuals is one that requires a better chance at the top prize than a fair gamble offers. Severe criminal sanctions suggest that a risk-avoiding offender would require a significant *odds premium*. In other words, a risk-avoiding criminal will try to transfer the risk of committing a severe crime such as murder to the greatest degree possible and thereby obtain the greatest *odds premium*.

Less successful attempts to transfer criminal risk suggest less risk-averse or even risk-seeking behavior. Because President Nixon's "white-house plumbers" were originally tasked with plugging information leaks related to national security, the "plumbers" were easily connected to the President. Finding it impossible to cover up subsequent investigations of "plumber" criminal activity because he failed to transfer the risk sufficiently, Nixon resigned. The possibility that someone would seek to avoid losses by less completely transferring risk suggests that they are relatively less risk-averse. In President Nixon's case, less risk-averse behavior probably occurred because president Nixon felt entitled to cover up security leaks and, therefore, that initial "plumber" activities would not be considered severe offenses.

Individuals can be risk-averse but face alternatives that involve particular circumstances that imply a preference for risk. For example, a loss avoidance scenario can arise in which a criminal choice may avert a large loss. According to Rabin (1998), since individuals have diminishing valuations of wealth far from a given bench

mark or norm, facing a large loss of wealth implies the individual prefers risk over this range of their utility function. The objective of loss avoidance may simply induce otherwise risk-averse individuals to gamble for criminal gains. For example, offenders who would seek to avoid losses from an impending divorce may be apprehended when they hire, or try to hire, a hit man because they leave easily observed connections among conspirators.

II. Risk-Aversion, Circumstances, and Actor Characteristics

A. Actor Characteristics and Mob Preferences

This paper first considers offenders who remain averse to criminal risk under all circumstances and conditions that are related to their corrupt acts. Such offenders must transfer all criminal risk through a corrupt exchange to other professional criminals. Transfers involve only an exchange of criminal favors. No money changes hands and no observable connection between parties is likely. A corrupt exchange scenario is developed that is consistent with behavior that is consistent with strong preferences for risk-aversion and with authoritative literature on organized crime and corruption.

As Dugan and Levitt (2002) indicate, "Because of corruption's illicit nature, those who engage in corruption attempt not to leave a trail. As a consequence, much of the existing evidence on corruption is anecdotal in nature." However, Dugan and Levitt (2002) refer to corruption in Sumo Wrestling. Influencing match outcomes is less severe than murder. A private citizen who pays for "crime insurance" for murder by transferring money or something tangible creates an observable linkage with other offenders carrying out the offense. Such a linkage reveals preferences for some

degree of criminal risk. On the other hand, a police or judicial official who pays for "crime insurance" by tipping off or otherwise assisting organized crime or any public official who directs business toward organized crime leaves a much less observable linkage among conspirators. Preferences for avoiding criminal risk are consistent with this scenario. Unless a private citizen can find a way to reduce detection among conspirators sufficiently such that they could be considered highly risk-averse, unconditionally risk-averse offenders involved in corrupt exchanges and severe crimes appear more likely to be public officials.

Fiorentini and Peltzman (1995) suggest that more effective deterrence activities increase the incentives for organized crime to invest in corruption and manipulation of deterrence agencies themselves. Organized crime benefits from corrupt public officials such as those in law enforcement. According to Marjit and Shi (1998), if corrupt law enforcement officials can manipulate the probability of detection of crime, crime can never be controlled. An example of an effective investigation that used electronic surveillance to probe the connection between the Chicago and Kansas City mobs and their skimming of Las Vegas casinos was FBI operation Strawman in the 1970s (see, for example, Thompson, 2004 or Hall, 1996). Let us assume that in response to FBI operation Strawman in Kansas City during the 1970s mobsters in Kansas City and Chicago now seek a corrupt public official in law enforcement that can help them reduce or eliminate the effectiveness of further surveillance and investigation.

B. Public Official Characteristics

A criminal justice official is dating his secretary and likely to be sued for divorce by his wife. If sued for divorce, the criminal justice official expects to lose

wealth. The probability that the lawsuit will occur is assumed greater than zero. If organized crime successfully carries out the murder of the criminal justice official's wife, the criminal justice official will avoid material and psychic losses. In exchange for the murder, the law enforcement official is expected to provide investigation details to organized crime members. The choice to enter into the corrupt exchange with organized crime is assumed free of any type of coercion.

C. Risk-Averse Preferences and Related Circumstances

Circumstances perceived as propitious by a risk-averse criminal justice official contemplating the decision to engage in a corrupt exchange that results in the murder of his wife include the following. First, criminal offenders may have established their reliability in previous contract murders. For example, Allen May (2000), indicates that the U. S. Senate committee on Organized Crime had identified Nick Civella in 1969 as being a principal member of the Kansas City Crime Family. Using tactics from undercover operation Strawman in Kansas City, the FBI picked up information through electronic surveillance that Civella and several others were involved in a gambling conspiracy involving the Kansas City and Minnesota Super Bowl. Civella and Sol Landie, a prominent local gambling figure, were indicted. Subsequent to their indictment, prosecutors gave Sol Landie immunity from prosecution for his testimony before a grand jury. Allen May states that, "In November 1970, four black men invaded Landie's home on the pretense of robbing him. Landie was murdered and his wife viciously raped by the intruders. The men were soon arrested and it was revealed that they were hired to kill Landie because of his testimony." For reasons not specified, Nick Civella was never sent to

trial on the original gambling charge or for the murder of Sol Landie. Moreover, there is no additional information involving the whereabouts or any legal consequences related to the four hit men who were arrested for the murder of Sol Landie. The use of experienced subcontractor murderers such as these by organized crime to carry out the murder of the risk averse criminal justice official's wife would be less likely to leave an observable connection between the criminal justice official and organized crime. Although some type of warning or message is sometimes an objective, Diego Gambetta (1996) makes it clear that the primary objective in mafia executions is to maximize efficiency.

A "code of silence" is a second reason for using organized and professional criminals to carry out crimes such as murder. Enforcing a "code of silence" among their members decreases criminal risk. Breaking the code means death. According to Witkin and Creighton (1994), even street gangs enforce such a code and this is one of the reasons that homicide clearance rates have steadily decreased since 1960. Professor Gerard Lynch (1987) indicates that the President's Commission on Law Enforcement and Administration of Justice reports that "organized criminal groups are known to operate in all sections of the Nation" and that the structure and workings include "codes of silence." For a risk-averse law enforcement official, a code of silence would be an attractive consequence of the decision to enter into a corrupt exchange with organized crime.

A third circumstance likely to be attractive to the risk-averse law enforcement official is that there may be other corrupt criminal justice officials working with the FBI who will be in a position to obstruct justice. In a newspaper article, Jeff Donn (2002) states that "... one former FBI agent, John Connolly, has been convicted of racketeering and obstruction of justice ... (and) had accepted bribes from the informant they were protecting.

Connolly . . . is accused of tipping Bulger and Flemmi (Boston's Winter Hill gang leaders) off to FBI investigations against them, information the government alleges led to three slayings . . ." Throughout the 1980s, state police tried to build a case against Stephen Flemmi and Bulger, but the pair was always one step ahead of them. The reason: Boston agents tipped them off, testimony in recent criminal cases has revealed." Flemmi was eventually arrested, Bulger fled and remains at large as one of the FBI's Top Ten Most Wanted criminals. Garuopa (2000) also shows that by gaining political influence through corruption, organized crime is welfare diminishing because it can then profitably increase the number of criminal offenses. Thus the corrupt criminal justice official may be joining forces with others who are corrupt and who will conspire to commit many more crimes.

Polinsky et. al, (2001) points out that (this type of) "corruption remains socially undesirable even if the fine can be raised to offset the deterrence-diluting effects of corruption. For example, if citizens tend to be risk-averse, innocent citizens who make extortion payments, or who are framed, still bear risk as a result of corruption." The criminal justice official in this example may actually assume that some innocent citizen will be framed for the murder of his wife.

A fourth risk reducing circumstance is that FBI profilers may become involved in trying to solve the murder of the criminal justice official's wife. Since the criminal justice official will benefit from the murder of his wife, local police may give the criminal justice official a polygraph examination. The action of giving the polygraph will indicate that the criminal justice official has a motive. However, a local police unit without investigative experience with sophisticated, experienced, and professional criminals will be unable to effectively investigate this type of crime and will assume a different

crime type. The polygraph examiner will consequently ask irrelevant questions and fail to detect deception by the criminal justice official. Political pressure to solve an important case that is without leads may cause FBI profilers to become involved in the investigation. Profilers will have to gamble on any number of assumptions about motive and crime type. Based upon additional assumptions that may be faulty, FBI profilers will develop statistically based profiles that extrapolate on biased data (see Turvey, 1999 and Marché, 1998) that contain little or no information about relatively more successful, risk-averse offenders.

One last circumstance that might encourage a risk-averse criminal justice official contemplating corruption is that the criminal justice official's means of payment to organized crime involves political and professional connections. If those connections can be exploited to the benefit of organized crime, then it follows that they can also be used to thwart or hamper any investigation into the criminal justice official's culpability in the murder of his wife. Exploiting connections may be easier in smaller cities and towns. David Bellis, in Alexander and Caiden (1985), argues that corruption in small cities or towns is common. Moreover, Fiorentini and Peltzman (1995) point out that social relations take a while to form and that small towns without social mobility and without competing police authorities provide ideal circumstances for corrupt relationships between bureaucrats and citizens.

III. Model Development

A. Variable Definitions

The criminal justice official's decision to engage in the corrupt exchange with organized crime and murder his wife will rest on the following variables:

W = the criminal justice official's initial wealth endowment. $W > 0$ must be assumed or wealth loss would be irrelevant.

p = the probability of an event (divorce) leading to a loss to the criminal justice official in the amount of L (where it is assumed that $p \geq 0$)

L = amount of wealth loss to the criminal justice official. $L \leq W$ is assumed.

G = gains (or rents) to the criminal justice official that result from the commission of a crime such as the murder of his wife. Effectively, G represents the dollar amount of insurance coverage.

CG = the premium cost C paid for G dollars worth of insurance.

The premium cost C is equal to the dollar value of the private "corruption" cost for insurance coverage G . CG includes all efforts to appear legitimate or innocent before and after receiving gains G as well as fulfilling all requirements of the corrupt exchange such as providing insider information to organized crime. It is assumed that the criminal justice official incurs no psychic cost from feeling guilty or disloyal (or that any such costs are offset by psychic gains).

B. Net Costs and Benefits

Risk of apprehension for the crime of murder is given by k . With $k = 0$, the odds premium is at its maximum. As in G. Becker (1968), the expected value of criminal gains is $EG = kU(G - f) + (1-k)U(G)$, where G is gains, f is the cost of punishment, and U is the utility function. Setting $k = 0$, $EG = U(G)$ and criminal gains (or rents) G appear sure to accrue from the murder of the criminal justice official's wife.

An examination of net costs and benefits yields similar information. Loss L is assumed limited by the initial wealth stock W of the criminal justice official. In contrast, G is not a bounded lump sum. In addition to preventing wealth losses equal to L , the murder creates circumstances that are more favorable to organized crime. This is because the criminal justice official must pay for the crime insurance, or corrupt exchange, by tipping off organized crime. Some of the increased organized crime rent may accrete, directly or indirectly, to the corrupt criminal justice official. Consequently, G is a potentially unlimited series of gains g_j where $G = \sum g_j$. For the corrupt criminal justice official, the net gain (rent) from murdering his wife is therefore $G - L \geq 0$.

Andrianova (2001) points out that the level of corruption gain (G) is a deciding factor in maintaining a bad reputation, such as incurring costs CG . Therefore, the private cost of G worth of insurance to the corrupt criminal justice official is equal to the private cost of criminal association or CG . Since CG is limited to include corrupt acts and to appear innocent, it is likely that, even in the event of a murder, $G > CG$ or $G - CG = (1 - C)G > 0$. In other words, net gains from murder must be expected. Consequently, the net private cost of the criminal association for a corrupt criminal justice official is $CG - G = (C - 1)G < 0$.

Some might argue that CG could be more for an elected official than for one who is appointed, or for a private citizen. After all, re-election appears to place an extra emphasis on the appearance of propriety. Perhaps this would be less of a problem for appointed officials or for private citizens who are less likely to be publicly scrutinized. However, several examples draw this hypothesis into question. For example, recently convicted U. S. Congressman Jim Traficant's well-established connections with organized crime did not seem to reduce loyalty among his political constituency.

In another example, even though the circumstances of White House counsel Vince Foster's death seemed highly suspicious (see Scalice, 1995), his death was eventually ruled a suicide based only on the circumstantial evidence of being treated for depression. Yet, no one in the Clinton White House, including his alleged boyhood friend, President Bill Clinton, demanded there be any further investigation. In fact, "the Clinton White House" expressed relief in response to hearing the final ruling. Will suspicious circumstances and Vince Foster's death really matter in any future election bids of former "Clinton White House" members who were Foster's former associates or, because he was the brother of one of the FBI's most wanted fugitives, James (Whitey) Bulger, was William Bulger's image more at stake? According to a CNN.com (2003) report, William Bulger was forced to resign as president of the University of Massachusetts because of a "calculated Political assault." On the other hand, this same report implies that William Bulger could easily have avoided being forced to resign if he had appeared more concerned about his brother's crimes and urged his brother to surrender.

Perhaps elected officials are not so easily scrutinized and face the same costs of corruption (CG) as appointed or other private citizens because elected officials may have a constituency more concerned with a political agenda. Moreover, constituency members may find it more in their political interest to shield their elected political representative from criminal investigation. In the Foster case, there is ample evidence of attempts to shield the White House from criminal investigation. For example, an infamous 60 Minute interview with Mike Wallace about the Vince Foster death investigation is referenced by articles titled "Mike Wallace's Fake Foster Probe" (Irvine and Goulden, 1995) and "Wallace and Ruddy: a journalistic drive-by shooting" (Murdoch,

1995). Shielding is unnecessary if there is nothing to shield.

C. Expected Cost and the Corrupt Exchange Decision

Net costs and benefits strongly show that a corrupt exchange between a risk-averse criminal justice official and organized crime that involves murder appears rational but is such a choice also optimal? As in Varian (1984), the first-order condition of the utility maximization problem for the criminal justice official is:

$$\max pU(W - L - CG + G) + (1-p)U(W - CG) \quad (1)$$

After taking the derivative with respect to G and setting it equal to zero we have:

$$pU'(W-L+G*(1-C))(1-C)-(1-p)U'(W-CG*)C=0 \quad (2)$$

$$\text{Rearranging terms gives,} \\ [W'(W-L+(1-C)G*)]/[U'(W-CG*)]=[(1-p)C]/[C/1-C] \quad (3)$$

If the loss-producing event (suit for divorce) does not occur, the private cost of criminal association for the criminal justice official is only CG. The criminal justice official may be providing insider information to organized crime at any time and at little personal cost. Costs increase if defending his or her image and reputation by having to explain an apparent connection with organized crime is required. In any case, $CG > 0$ is reasonably assumed. Given this, the *expected cost* of the corrupt exchange to the corrupt criminal justice official is:

$$-p(1-C)G+(1-p)CG<0 \quad (4)$$

In other words, the *expected cost* of criminal association and a corrupt exchange for a criminal justice

official is less than zero because G has no upward bound, CG has an upward limit, and $(1 - C)G > 0$.

Assuming the corrupt official faces the worst case scenario such that the expected cost of the corrupt exchange is equal to zero we get

$$\begin{aligned} -p(1-C)G+(1-p)CG=0 & \quad \text{or} & (5) \\ (1-p)CG = p(1-C)G & \end{aligned}$$

Substituting (5) into the first - order conditions for utility maximization produces the unconstrained maximum

$$U'(W - L + (1 - C)G^*) = U'(W - CG^*) \quad (6)$$

If the criminal justice official is strictly risk-averse so that $U''(W) < 0$, the acceptance set of the corrupt criminal justice official is convex and optimizing behavior is implied such that

$$\begin{aligned} W - L + (1 - C)G^* &= W - CG^* & (7) \\ -L + G^* - CG^* &= -CG^* \\ L &= G^* \end{aligned}$$

Thus, even in the worst case scenario in which criminal gains (rents) G are limited to avoiding wealth lose L , a risk-averse criminal justice official will agree to buy G dollars worth of crime insurance in the form of a corrupt exchange with organized crime. The loss avoiding crime may be the murder of the criminal justice official's wife and the corrupt exchange may entail the criminal justice official paying for the "crime insurance" by informing organized crime about investigations. It is assumed that the murder carries no risk of criminal sanction and that the criminal justice official suffers no remorse. As in Polinsky et. al., (2001), it is assumed that all risk of criminal sanction is born by "third party" citizens who may be framed for the crime.

IV. Less Risk-Averse Officials

An expected utility function for any type of crime or corruption scheme can be adapted from Gary Becker's (1968) general model for crime and Ehrlich's (1996) supply of offense function. Ehrlich (1996) adds the individual's cost of acquiring criminal gains. Combining Becker's (1968) and Ehrlich's (1996) functions, the expected utility of any corruption scheme S can be written as

$$EU_s = pU_s(G - C - f) + (1-p)U_s(G - C) \quad (8)$$

where U is the utility function, G is gains (psychic, emotional, and material), C is the individual cost of acquiring the loot, p is the risk of apprehension and punishment, and f is the level of punishment for the crime. The opportunity cost of the corruption scheme S is the expected opportunity cost of legitimately acquired gains (Y) where

$$EU_i = U_i(Y) \quad (9)$$

For a particular corruption scheme (S) to be perceived as rational, $S(EU_s - EU_i) > 0$ is required. If the official or other individual acts as though s/he is less risk averse such as being more careless in carrying out the scheme, then behavior consistent with preferences for less risk-aversion can be inferred. For convenience, assume risk-neutrality. The lower risk premium required means that EU_s is reduced. This occurs because risk (p) in equation (8) is increased. If the crime involves severe consequences such that punishment (f) remains high, it is unlikely that such a scheme will be perceived as a rational alternative. Assuming psychic and emotional gains are constant for a given corruption scheme, compensation for increased risk (p) requires increased

emphasis on increasing material gains in G . Moreover, since G is net of the individual cost C of acquiring them, C may be minimized. Minimizing the individual cost of acquiring gains from corruption suggests that corrupt individuals will tend to involve themselves in simpler schemes or that their individual role will be reduced such that a greater proportion of the corruption process is undertaken by others.

V. Conclusion

Risk aversion, risk transfer through corrupt exchange, and criminal success appear interrelated. A person who appears averse to criminal risk, even pious, can optimally choose corruption and murder. Criminal risk can be transferred from a public official (or other individual) to professional criminals in a manner analogous to buying insurance. The transaction is a form of corrupt exchange. It is conceivable that professional offender groups who accept criminal risk in exchange for some type of "fee" may range from local criminal gangs to State security agencies.

Criminal risk-aversion requires a higher risk premium to gamble on the success of any corruption scheme. Lower risk premiums are associated with a lower level of certainty and, all else equal, the more likely that the corruption scheme will be detected. It is reasonable to expect that corrupt exchange schemes with greater detection risk will involve crimes less serious than murder, emphasize material gains, or require that corrupt officials play a relatively smaller role in corrupt activities.

There may be clues to detecting a corrupt exchange between organized crime and highly risk-averse public or criminal justice officials that involve highly serious crimes such as murder or treason. Crime benefits accrue for an apparently risk-averse offender and, in

exchange, some form of non-monetary payment is made to those carrying out the crime from which benefits accrue. Public officials benefiting from crime will exhibit little or no genuine interest in having the crime investigated. Moreover, corrupt public and law enforcement officials may rely on political and professional connections to thwart subsequent investigation or to aid in lowering the private cost of appearing corrupt. Related to lowering the cost of appearing corrupt, it follows that if confronted by evidence linking the risk-averse crime beneficiary (or beneficiaries) to the corrupt exchange, effort will be made, through political or professional connections, to discredit such evidence. A corrupt public or law enforcement official may also discredit evidence and lower the private cost of appearing corrupt by appearing pious or self-righteous. It is also possible that the desire for the highest possible risk premium and the lowest cost of appearing corrupt may lead risk-averse and corrupt public officials to engage in some types of manipulative actions prior to a beneficial criminal event that would hamper a subsequent criminal investigation. Risk-aversion and risk transfer to professional offenders means that corrupt officials will have an alibi. Minimizing the cost of the public official appearing corrupt and increasing the risk premium nearer to certainty suggests that professional criminals will stage the crime scene to appear so as to appear as another and more common crime type (e.g., suicide, or murder-robbery, etc).

Risk-averse criminal conspirators are expected to be more sensitive to punishment than apprehension risk (see Becker, 1968). Thus, when confronted with evidence that cannot be easily discredited, and assuming no diplomatic immunity or other effective shielding, corrupt public officials may be relatively more willing to cooperate with authorities if the level of punishment can be negotiated.

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THE GENESIS OF CAPITALISM: THE NEXUS BETWEEN “POLITICS IN COMMAND” AND SOCIAL ENGINEERING

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Abstract

This paper aims to offer a framework of interpreting the “evolution” of capitalism that is reaching every corner of the world and has achieved greater legitimacy than at any time in human history. It covers an interdisciplinary discussion on the development of market capitalism that has been characterized by a dual process: unanticipated origin (cultural and historical) and anticipated progress (political economy).

The point of departure of this paper is that although the advancement of market capitalism is a process of societal development involving historical, cultural and religious causes (historical, divine, spiritual, miraculous), the establishment of capitalism is less the result of a force for cultural and economic dynamism than the realization of a political project. In other words, from being an enterprise within defined geographical boundaries to becoming a global project is first and foremost a transformative process involving political repercussions as being dealt with here (enforced variation, reshaping, selection and distortion).

In sum, the paper intends to problematize the significance of the evolutionary explanation, the culturalist approach as well as the economic perspectives on the birth and expansion of capitalism and instead emphasizes the role of political power in its development and present-day stage. Politics to a great extent is undertakings of coercion, rationalization, legitimization and imposition which are the essence of

market capitalism itself, i.e. politically motivated social engineering.

Key words: capitalism, market, religion, reformation, deformation, politics

Analytical considerations

The axiom that the victor writes (his)story influences the conceptualization of contemporary capitalism. Seen in this light, the process of globalization (or Westernization as many also term it) affecting almost every aspect of human activity is taken as the logical outcome of the evolution of societal organization.

The rationale for this position is found in the econocentrism of the “secular mind” (Coles, 1999) which sees modernity as the culmination of economic rationality, progressive spirituality and the faith of modernization. Through this prism, it is believed that humanity has entered the ultimate phase of its evolution, as expressed in the thesis on “the end of history” (Fukuyama, 1992). But as Anthony Giddens has put it “rather than entering a period of post-modernism, we are moving into one in which the consequences of modernity are becoming more radicalized and universalized than before” (1991:3).

In its endeavor to ascribe legitimacy to the social order of “real existing” capitalism, conventional thinking relies on neoliberalism which has become the dominant paradigm of economics. Its ideological foundations are found in the social and political philosophy of emerging capitalism based on the concept of individual freedom and democracy, causes that emanated in the struggle against the feudal order.

Acceptance of globalization as the child of historical capitalism opens for a problematization of the past in

order to understand the present and reflect on the future. However, just as conceptualizing the present, understanding the history of capitalism is an arena of conflict within the social sciences. In its long march towards achieving hegemony, the capitalist worldview was constantly resisted by another approach which challenged it ideologically and politically. Awareness of this confrontation contributes to making sense of a historical process that would otherwise be at the mercy of the system's proponents' interpretation. In the words of Samir Amin:

As far as modern history is concerned, that of capitalism, two discourses have been in opposition to each other in the past two centuries; and never could the one convince the adherents of the other. There is on the one hand the conservative discourse, which legitimizes the capitalist social order, and on the other hand, there is the socialist discourse which submits it to a radical critique (Amin, 1997:10).

The point, which deserves transparency in dealing with social theoretical constructions, is that they do not operate in politico-ideological vacuums. Given the societal context in which they operate, they come to serve the aims of special interest groups that find it worthwhile to support and encourage the one against the other. As Robert Cox doesn't tire in telling us: "Theory is always for someone and for some purpose. We need to know the context in which theory is produced and used; and we need to know whether the aim of the user is to maintain the existing social order or to change it" (Cox, 1995:31).

The arena of contest between different ideological/scientific paradigms is located of course within the confines of the power structure of societies.

This explains that while capitalist economic theory found it difficult to penetrate the realm of state socialism, socialist critique of capitalism likewise was put at a disadvantage as a result of the hegemony of liberalism in the "free world".

In capitalist society – which is the focus of this paper – social conflicts of one or another kind are always present. Under those circumstances one aspect of power relations is the ability to control the agenda of confrontation (Bachrach and Baratz, 1962). A good example of this is the fact that in the United States the struggle over the ownership of the means of production has almost always been kept out of the public agenda (Ross and Frachte, 1990: 9).

Thus not only is power reflected in the ability to prevail in conflict, it is also the capacity to determine the conceptualization of the issues involved. In this context socialization and social control play an important role in stratified societies. The secret charm of dominant power under such circumstances is attained if it can be dispensed in a consensual frame. As Ross and Frachte put it:

The hegemony of capitalist culture, and the perceived realities of political choice are such that the given structure of choice appears to be rational, inevitable, "natural". There is often no "politics", that is, no large scale conflict or explicit contention about this structure of choice, because it has been accepted by potentially contending parties before public agendas are constructed". (ibid., 9)

It is within this critical frame of reference that this article discusses the genesis of global capitalism by critically focusing on the conventional reading of the

emergence and development process of this social formation.

Objective: understanding the evolution of capitalism

For the last two centuries, scholars and researchers have attempted to find answers to questions such as “Why did capitalism evolve in medieval Europe and not in China, India or anywhere else?” and “what were the necessary building blocks of capitalism?”, and “what makes this economic system such a powerful global project?” Different explanations have been offered putting emphasis on different historical, cultural and social factors or aspects.

The conventional framework for understanding and interpreting these elements and their causal correlations is found in the discussion of how economic and cultural processes interact to shape and reshape the socio-economic environment in the evolution of market capitalism. In this context, the point of departure of this paper is the assumption that although the advancement of market capitalism is a historical societal process including cultural and religious dimensions (historical, divine, spiritual, miraculous), the establishment of capitalism is less the result of cultural and economic dynamism than the outcome of a political project. In other words, market capitalism is first and foremost a coercive political enterprise process with societal repercussion (enforced variation, reshaping, selection and distortion). Viewed in this light, we need to realize that we are dealing with a rationalizing, legitimizing and imposing political undertaking which is fundamentally at the heart of market capitalism. Given this background, the study of capitalism becomes the principal objective of political economy.

Market capitalism: the new secular religion

In the evolution of mankind, worship of a god was in many societies the point of reference for the construction of reality on which individuals' worldview was conceptualized. Religion as a belief system constituted not only the ideological cement of society, but the only way of comprehending the world. The conceptualization system of society offered little apart from reflection on the religious view of the cosmos. With the advancement of societal evolution following the development of science and technology, human society experienced recurring paradigm shifts during various periods of history, which in turn gave rise to different types of social theories. In other words, new material conditions and political institutions demanded different systems of thought and explanations.

Serving as a scientific explanation system the free market has become the central category and the core of the discipline of economics. As Blaug points out: “The history of economic thought ... is nothing but the history of our efforts to understand the workings of an economy based on market transactions” (1985:6). Accordingly conventional economics can be seen as the theoretical construction of capitalism. Rule also emphasizes the importance that the phenomenon plays in the modern mindset, “When historians of ideas go to work on the last decade of the twentieth century, the market will surely appear as one of our intellectual totems. What the Rights of Man were to the French Revolution – or what Manifest Destiny or the quest for the Kingdom of God on Earth were to their times – the market is to our own” (1998:29). Nevertheless, it must not be forgotten that economics as an independent discipline is a relatively modern phenomenon, and that until the mid-1700s “economics was generally discussed as a subordinate part of a

broader study of political, moral and theological matters” (Alvey, 1999:55).

In the similar vein, Robert H. Nelson, presents in his volume *Economics as Religion: From Samuelson to Chicago and Beyond* a significant analytical contribution in uncovering an important dimension of economics as a discipline and profession. In Nelson’s view (2002), the religion of the modern secular world is scientific materialism in which the theological faith is located in economics/the market that brooks no questioning and challenge. The point of departure of its rationality, reasoning, conceptualization and understanding is based on what can be observed through the senses and what can be verified empirically. Nonmaterial/nonscientific explanations including non-measurable phenomena are dismissed or ignored. Economists, like the older ministerial classes of Christianity, have been playing the priestly role in the rationalization and deification of “value-free economics” and material progress as well as in asserting its strong influence in the social and political world.

The consequence of this tour de force which reduces all aspects of society to economic calculations is a prototype of ideological “soft totalitarianism.” As a student of this evolution puts it: “Apart from presenting the ‘economic’ as its own sphere, removed from the reaches of democratic control, the politics of economism also tends to subordinate other social spheres to its normative supremacy” (Teivainen, 2002:2).

The deification of the market and economics¹

The 20th century is often described as the “American Century”. With globalization, the American Creed, which embraces worship of free markets, free elections, individual freedom and rights, liberal democracy, has become canonized. This gospel appears to have

achieved the status of a world religion. To most people in the United States, market capitalism is ideologically speaking becoming a kind of orthodoxy. That capitalism is the only way leading to happiness and well-being is taken as an article of faith. Any questioning of these basic tenets is considered to be heretical and the skeptics risk marginalization by mainstream opinion. Liberal economics has become theology. Even religion in today’s US is so commercialized that “God is for sale”, thus becoming a material and commodity for competition and consumption (Moore, 1994).

In the process of having achieved a hegemonic position within economics, operations and interactions within the market are construed as value-free and neutral objective, implicitly suggesting that like God the market cannot be judged normatively. In the view of the Central American Jesuit theologian and philosopher Franz Hinkelammert, the market is raised to a holy status level so that it can “judge over life and death but cannot itself be judged in terms of the effect it has on the life and death of every individual” (quoted in George and Sabelli (1994:96)). Harvey Cox observes that, in many ways there is a strong resemblance between the Western theological doctrines of religion and the modern market ideology in which the almighty market has become godlike (Cox, 1999:20-22).

Firstly, like God the market is attributed *omnipotence* (ultimate universal power). In the ancient era, the market was never godlike or the only deity because there were other centers of value and meaning. It is only in the last two centuries that the market has become transformed into the dominant divinity. Now, the market defines truth and possesses the divine power to “make something out of nothing and nothing out of something”, such as converting earth and land to real estate, and human body to commodities (Cox, *ibid.*:20).

Secondly, like God the market is considered to be equipped by nature with *omniscience* (all knowledge and the truth). Human beings have to understand the market's wisdom which will, in return, shape our needs, determine whether, when, where, how to buy and sell. The market knows "the deepest secrets and darkest desires of our heart" and "... by probing our inmost fears and desires and then dispensing across-the-board solutions, it can further extend its reach." Thus, "... to question the omniscience of The Market is to question the inscrutable wisdom of Providence" (Cox, *ibid.*:22).

Thirdly, like God the market is ascribed the power of *omnipresence* (universal existence, everywhere regardless of whether one can see it or not). Consequently, the market is supposed to have everything to do with economics and societal development, and it is also believed to have close influence on every aspect of human life:

... The Market is not only around us but inside us, informing our senses and our feelings. There seems to be nowhere left to flee from its untiring quest. Like the Hound of Heaven, it pursues us home from the mall and into the nursery and the bedroom. (Cox, *ibid.*:23)

The market's mode of functioning is raised to the standing of a natural law. In the words of a Protestant thinker, "The laws of the market ... come to be seen as transcendent, [undergoing] a process of sociological sacralization. Not only are they given a higher status, they actually become untouchable, like the laws of nature" (cf. George and Sabelli, 1994:96-97). The contemporary doctrine of "market populism" – the presumption that the market and democracy are the two sides of the same coin, and that the market represents not only mediums of exchange but also mediums of

consent – has become the pivotal ideology of our time (Frank, 2001). In this way, the "invisible hand" of the market is like the hand of God holding the final truth of all interactions and phenomena.

As a consequence, economics implicitly becomes theological doxy and a science – an organized system of explanations to make sense of the real world and life. Within this type of explanatory catechism, there are a number of doctrinal principles which are taken as guidelines for human behavior and societal development:

1) The market is the invisible hand representing absolute and universal rules and laws. In this sense, the IMF, the World Bank, and the WTO are the legislating bodies of market laws on behalf of the highest authority: the dismantling of mandatory planning, the opening up of the economy to international competition, the implementation of financial liquidation and bankruptcy, the introduction of bonds, shares, and stock market for primary and secondary trading, the acceptance of international competition and integration with foreign trade and financial transactions, the privatization of state-owned companies, the diversification of ownership forms (private, joint-venture, state, and foreign), greater flexibility and mobility of labor and population, free prices, the removal of subsidies, closing 'inefficient' enterprises and the laying-off of redundant workers.

2) Market rules and laws are inalterable like those of nature. Those who obey the principles will be awarded, and those who defy them, such as Soviet socialism, Asia's "crony capitalism", Russian "mafia capitalism" as well as other types of statist capitalism, will be considered abhorrent and thus sooner or later will be punished.

3) In order for developing and transitional societies to ensure that these fundamental principles are accepted and maintained, certain sacrifices and painful reforms or

adjustments, such as “shock therapy” and various structural adjustment programmes, etc., are deemed to be necessary.

4) Regardless of the fact that inequalities and crises in many parts of the world may seem to contradict the ideals of market rules and laws, it is believed that these flaws including poverty, environmental pollutions and ecological degradations, can be corrected in the long run without abandoning market fundamentals.

5) Those who challenge such principles and attempt to find alternatives, such as statism or other forms of communitarianism, are seen as challenging the only viable political and economic system conducive to human happiness and prosperity. As a consequence of the defeat of state socialism and the spread of liberalism and market capitalism, humanity is claimed to have arrived at the “end of history” (Fukuyama, 1992).

Market capitalism and civilization specificities

Whether market capitalism is the natural outcome of human civilizations or not is an essential issue. The answer to this question is determinant to the understanding of present-day contradictions in the world. It is argued here that the free market as an exchange instrument is the product generated by a specific development process within specific geographic areas. In other words, it can be conceptualized as a socio-cultural entity. To say that the free market is a socio-cultural institution is to suggest that the way people interact in the exchange process (regulating and coordinating their economic behaviors) shapes people's identity and behavior.

According to Wilk's studies on the relationship between economy and culture (see Acheson 1997: 233-234), economic anthropology has shown that economic arrangements are based on one of three assumptions

about human nature. The first regards humans as economic beings who are motivated by self-interest and who are strongly associated with the free market where autonomous profit-seeking individuals interact with one another without much concern to ties of kinship or community. The second sees humans as social beings whose behaviors are molded in association within groups. Several approaches of political economy including Marxism are related to this interpretation. The third believes that humans are moral or ethical beings whose worldview is shaped by a set of values. This is what Wilk identifies as “cultural economics.”

Max Weber can be identified as related to the last supposition. In his *Economy and Society* (1921) he analyses the main aspects of economic rationality in a capitalist society in the West and contrasts them with economic orientations in other types of society. These characteristics of rationality find their expression in: market exchange, where transactions are determined only by the pursuit of interests; generalized use of money as means of rational capital accounting; the rational management of labour in production and strict factory discipline; rational technology; clear separation of the enterprise from the household. Moreover, these economic features are assisted by extra-economic public goods, such as the functioning of government administration and the legal system, which guarantee the reliability of all contracts entered in the market.

Weber argued that a unique causal connection existed between the spiritual and the temporal, namely the effect of religion (Lutheranism and Calvinism) on the development of capitalism especially in terms of: 1) rationalization and creativity of economic activities; 2) organization of political and social life; 3) rational organization of free labour (separation of productive activity from the household); 4) modern book-keeping system; and 5) industrial organization. These

characteristics are depicted as unique cultural phenomena of Western civilization and as the elements behind the emergence of capitalism in Europe. The conclusion that follows from this conceptualization is that the lack of the same distinctive traits explains why capitalism failed to emerge in other historically advanced civilizations such as China and India.

Social scientists have since Weber debated in a manner of either agreeing or disagreeing with him. In similarity with the Weberian conceptualization but in a developmental context, some scholars, such as de Soto (2000), take up the question, which many people have been asking and studying and which is one of the most debated issues the world faces today: Why do some countries succeed in developing capitalism while others fail? As an institutionalist economist, de Soto attempts to show that historically speaking every developed nation in the world at one time went through the transformation process from predominantly informal, extra-legal ownership forms to a formal, codified property law system in which people are allowed to leverage property into wealth. In line with this type of thinking, it is therefore not because of the lack of salable assets or the shortage of entrepreneurial spirit, but the lack of institutionalization that some countries fail to make capitalism flourish. This approach's shortcoming is that evidence shows that the establishment of a capitalist-friendly legal infrastructure cannot be realized outside the compatible environment of cultural values and social norms. In addition, it should not be ignored that many developing countries were/are actually burdened by political turmoil and social unrest due to the privatization process of the structural transformation of property relations imposed by Western-oriented economic development and expropriation of parts of the economic surplus through debt servicing.

It is argued by some Weberians that the rise of market capitalism was an outcome of a peculiar institutional development which found its clearest expression in the capitalist economy. This evolution refers to the nuclear core of social and cultural institutions, the historical role of a particular *family* type - individualistic bourgeois family with its social habits and norms; this is claimed to be "the only institution sufficiently dynamic to spontaneously engender social processes that made for both the development of a modern market economy and the rise of civil society during the 18th and 19th centuries in the northwestern part of Europe" (Berger, 1998: 45). Furthermore, it is perceived to be "the core features of any social order based on the principles of individual liberty, political democracy, and a market economy" (ibid.: 45). During the societal transition from family to factory production, the division of labour increased and economic activities based on the family also moved to the firm. Likewise, with the emergence of a formal education system, education and training functions previously provided by the family and church were replaced by a specialized institution - the school.

In the middle of the 18th century, the European feudal era was in a gradual process of eroding. The old social and political order in which the elites including monarchies, the Church, the land-aristocracies as well as the bourgeoisies formed the ruling coalition in the appropriation of the lion's share of the economic surplus, began to waver. The emerging wealthy business sectors, being tired of resisting the older political hierarchies, opted for republican state-forms as a better political environment for the further development of their economic activities. However, they also understood that the only way to lead society on the road to capitalism was to gain access to *political power*. Therefore, they took the advantage of the people's discontent by promising a democratic republic under the spirit and

principle of liberty, equality, fraternity as well as offering popular participation in the new regime. The “people power”, first in France and later in the United States, overthrew the old regimes. In the course of the two centuries since, the discourse of freedom, rights, liberty, equality and fraternity has been associated with capitalism.

Western secularization in historical perspectives

The breaking-up of the old order resulted in the dissolution of the political and spiritual dominance of nobility and Church. The concept of “secularization” entailed a long historical evolution and societal development characterized by intense conflicts, struggles, transformations, and changes which accompanied the process whereby religious ideas and teachings came to be considered as having no inherent value to society and development. It also has come to imply a sense of triumphalism, a pervasive assertiveness of modern Western civilization, which seeks to establish its cultural values as having universal validity regarding the past, present, and future. Less optimistic is the thesis of cultural clashes that projected to be the profound source of potential conflicts between the West and the rest since the systemic contest with socialism has been resolved in favor of capitalism (Huntington, 1996).

Historical perspectives

The gradual development of modern secular society in the West led to the separation of Church from the state (or politics). Religion has been transformed in such a manner as to become a matter of personal preference for each individual. Furthermore, it is generally accepted that the Church should have no role to play within the

affairs of the state or the society at large. In secular society the role of religion is seen as subservient to the interests of the state. This is the common understanding of a modern society in today’s world. Secularism has reached its strongest manifestation in the West, which historically forced most other nations to adopt this course either through military and economic means, or through cultural and educational influences. This notwithstanding, the entire phase of colonization and colonialism was based on the messianic pillar of bringing Christianity to the non-European people of Africa, Asia and South America.

In the Middle Ages, Europe was ruled by a feudal system upheld by the Monarch, Nobility and the Church. The principle of religious philosophy that man’s life was predestined by God helped feudalism to maintain the status quo and oppression over society. Dissident humanist philosophies were suppressed by the power of the Church. Those who defied the prevailing religious dogmas were banished, tortured or executed. The term “Middle Ages” was often used synonymously with the “Dark Ages” as Europe was in the darkest period of its history.

The feudal system began to collapse due to a number of parallel developments and challenges causing the gradual marginalization of the Church. The first was the revolution in science (Hall, 1983), which started to play an important role in Europe and lead to the confrontation with the teachings of the Church. The law of gravity, the revolution in astronomy, the innovation in biology etc, represented challenges to the existing fundamental assumptions leading to what Thomas Kuhn (1970) referred to as changes of *paradigms*².

The second ideological challenge was the Renaissance and intellectual libertarianism which found expression in the flourishing of art, music, literature, philosophy and exploration, as well as the attacks on the

dominance of religion and the belief system based on superstition. Humanism in the West denoted a break with religious mysticism, thereby drawing a distinction between God and man believing that man was born to be free and human existence should not be predetermined by God. These teachings are now widely regarded as the philosophical sources of Western human rights and democracy.

The third challenge to the established structures of feudalism and emerging agrarian capitalism was the Industrial Revolution, which transformed Europe (first England and the Netherlands³) into manufacturing capitalism much earlier than the rest of the world and which provided Europe with powerful weapons for imperial expansion and colonization supplanting the earlier mercantilistic phase. In the view of the functional approach, this forceful development transformed society from "a holistic traditional life form permeated by religion toward a steadily increased *differentiation* of social functions leading to the marginalization and even obsolescence of religion" (Dallmayr, 1999:718, *italic* added). This transformation also developed newer social categories and relations - industrialists and workers - in the emergence of the nation-state. The final establishment of the capitalist system in Europe as manifested by commercial interests, free trade, market expansion and profit-earning, marked the end of the dominance of the old system leading to *the rise of new centers of power*.

The marginalization of the dogma and role of religion in Europe represented a process of ideological transformation from the "age of faith" (Church-State) to the "age of reason" (nation-state). Faith is the strongest indication of belief in truth even in the absence of any objective fact or in opposition to observable evidence. The age of reason indicates that truth can solely be

obtained by a process of rational and logical thinking which is based on the evidence provided by the senses.

Capitalism and religious reformation/deformation

In addition to the above mentioned historical influences on the evolution of secularism in the West, another explanation which may have facilitated its emergence in Europe was that, although many political ideological systems were generated by Western civilization, the West has not given birth to any native-born religion. As Huntington notes:

The great political ideologies of the twentieth century include liberalism, socialism, anarchism, corporatism, Marxism, communism, social democracy, conservatism, nationalism, fascism, and Christian democracy. They all share one thing in common: they are products of Western civilization. No other civilization has generated a significant political ideology. The West, however, has never generated a major religion. The great religions of the world are all products of non-Western civilizations and, in most cases, antedate Western civilization (Huntington, 1996:53-54).

It can be deduced from this recognition that since Christianity was not of Western origin, the possibilities of *reformation*⁴ within the Christian religion could not but result in a deformed belief system, i.e. the *Protestant deformation* (Kurth, 1998). Deformation implies a process of reshaping, changing and finally transforming the original ideas into a modified moral and ethical system. It marked the beginning of Protestantism, and represented a major break in the theological dogma of

Christianity. Far from being marginalized, religion was seen as a pioneer of capitalist behavior.

The cultural and religious uniqueness of the West

Max Weber is known for his writings on the rise of capitalism in the West from the perspectives of culture and religion. He theorized the deformation process (i.e. “rationalization process”) – as the outcome of the relationship between Protestantism, especially Calvinism, and the rise of capitalism in the West. His thesis was that religion (Protestantism) played a positive role in the rapid development of capitalism in Europe.

According to this interpretation of the rise of modern capitalism, religious (Calvinist) spirituality was secularized when the dedication to the task of societal regeneration became linked to the generalization and multiplication of capital and when profit-making was turned into an ethos, a moral crusade.⁵ Weber’s thesis is explained by David Loy as follows:

Calvinist belief in predestination encouraged what became an irresistible need to determine whether one was among the chosen; economic success in this world came to be accepted as demonstrating God’s favor; this created the psychological and sociological conditions for importing ascetic values from the monastery into worldly vocations, as one labored to prove oneself saved by reinvesting any surplus rather than consuming it. (Loy, 1997)

Accordingly, this gave birth to a socio-economic evolution which began to function in a manner independent of religion while the latter was compelled to comply with the economic logic. As Marx vividly remarked, “The English Established Church, e.g., will

more readily pardon an attack on 38 of its 39 articles than on 1/39 of its income” (Marx, 1977:10). That is to say, the original motivation behind “capitalist spirituality” gradually became irrelevant with maturing capitalism. When the preoccupation with *market, capital and profit* develops into the engine of economic growth, it has not only survived but has also become the core of modern economics as the only rational and scientific explanatory system.

Historically, the Protestant tradition rejected hierarchy and community as means to salvation. Protestantism was “a protest against the form that the Christian religion had taken in the Roman Catholicism of the late Middle Ages and Renaissance.” (Kurth, 1998:224) In the economic sphere, the common characteristic of Protestant entrepreneurs was that their “religious feeling was often intense but essentially private and personal” with a desire “to be left alone by religious enthusiasts and organizers and to escape from the clericalist and cannon-law network” (Johnson, 1993:34). In fact, many tended to emigrate to places where religious rules were relaxed and where they could develop their innovative energies and capabilities⁶. The religious dimension in the history of capitalism in the United States is often used as a case in point to support this type of explanation. Even today, the clue to American economic superiority over that of Europe is argued to be found in the “God factor”, i.e. the pious, industrious and hard-working United States that was born from and has kept the Protestant spirit of capitalism is said to be in clear contrast to the decline and fall of the spirit of Christian asceticism in Europe, which manifests itself in decreasing working hours, increasing strikes, declining church attendance and believing less in God (Ferguson, 2003).

Besides Weber, Hegel and Marx also accepted the aspects of the culturalist explanation as to why

Occidental (Western) societies were able to achieve industrialization earlier than the rest of the world, and why the *Oriental* (Asian) societies failed to do so.⁷ Their explanations were based on the perceptions that traditional religions (inward, static), cultures (Confucianism, communal and collective) and social/political patterns (bureaucratic, absolutist) in oriental societies were structural barriers inimical to the development of capitalism whose dynamism requires innovation, incentives, self-interest and individualism. This also denotes the recognition that modernization is preconditioned on cultural capital and ideological attitudes which must be receptive to capitalism.

Given this ascription to the importance of capitalism's cultural precondition, it is not surprising that this line of thinking achieved paradigmatic preeminence within the most dominant development theory, i.e. the modernization school, which has exerted great influence on policy-making in the context of the Third World. Since the Second World War, the dichotomy of tradition-modernity has received more than its share of attention. As spelt out by Sadie, development denotes a complete cultural transformation:

Economic development of an underdeveloped people by themselves is not compatible with the maintenance of their traditional customs and mores. A break with the latter is a prerequisite to economic progress. What is needed is a revolution in the totality of social, cultural and religious institutions and habits, and thus in their psychological attitude, their philosophy and way of life. What is, therefore, required amounts in reality to social disorganization. Unhappiness and discontentment in the sense of wanting more than is obtainable at any moment is to be generated." (1960:302)

The disembodiment of modern society from its traditional context can paradoxically be noted in the transformation of modern capitalism which now "stands in opposition to Calvinism and to religion in general." The reason for that transformation is that the dominant market economy has become an entity that combines norms, values, markets, money, and laws as an *unanticipated consequence* of the Protestant ethic because "people create social structures but that those structures soon take on a life of their own, over which the creators have little or no control. Because people lack control over them, structures are free to develop in a variety of totally unanticipated directions" (Ritzer, 1996:149). In other words, the derivations of Protestantism in the rise of capitalism were later transformed into a unique deformed capitalist system of its own which is what we are experiencing today.

In line with this interpretation, modern secular politics can be viewed as an unanticipated consequence of the market mechanism determined by the inherent profit-making logic of capitalism. Not only nation-states but the entire system of international relations are directly or indirectly connected with this outcome. Politics in the West, whether domestic or international, is generally perceived in terms of power, government, national interest and patriotism, and are often associated with political parties, division and balance of power, and mutual checks. All of these have no foundation in the original Christian principles.

The central theme I: an anticipated deformation

While many scholars agree with the Weberian notion that market capitalism developed as a historically and culturally specific socio-economic formation in which religious ethics played a certain role in its origin, others

such as Karl Polanyi disagree with the culturalist thesis of modern capitalism as an unanticipated consequence of religious ethics. Whether the transformation from religious deformation was marked by an unwillingness to adhere to any particular doctrine or by the antagonism of strictly institutionalized and clericalized Christianity towards the progressive elements identified with the capitalist system is an anticipated or unanticipated process is an issue of debate. The following two sections of this paper highlight a critical discussion of classical economics and Weberian culturalism as well as bring into light our views on the role of politics in the genesis of capitalism.

The political economy of Transformation and catching-up

The transformation of the market place as an institution of exchange into a market system of capital accumulation is what distinguishes capitalism from pre-capitalist societies. The history of the market can be said to reach back several thousands of years to the post-neolithic times according to two German political economists who point out that the specific integration of different economic elements in this system – the “market economisation” (Vermarktwirtschaftung) of land, natural resources, labour power, and money – is of later date. Only since the Industrial Revolution can we speak of the “market economy” as a totality (Altvater and Mahnkopf, 1997).

According to economic anthropology, the modern capitalist mode of production differentiates itself from all preceding ways of organizing material life and social reproduction. It is distinctive in the way that economic relations (actors and institutions) are separated from non-economic relations – a distinction between a society with market and a market society (Polanyi, 1957). A

market society implies that society itself has become an “adjunct” of the market. And a market economy can exist only in a market society because social relations in such a society are embedded in the economy rather than the other way around – i.e. an economy embedded in social relations (Wood, 1999).

The importance of this argumentation – which goes against the classical and liberal orthodoxy – is that the market as such is not a natural phenomenon; nor is it a reflection of human nature. It emerged neither from the spontaneous interaction of autonomous individuals, nor as an unanticipated consequence of Protestant ethics. Although Polanyi recognized the existence of unintended consequences in social life, he strongly believed that economic and trade relations necessitated centrally organized and controlled interventionism:

There was nothing natural about laissez-faire; free markets could never have come into being merely by allowing things to take their course. ... Laissez-faire itself was enforced by the state. The [1830s and 1840s] saw not only an outburst of legislation repealing restrictive regulations, but also an enormous increase in the administrative bureaucracy able to fulfill the tasks set by the adherents of liberalism. ... Laissez-faire was not a method to achieve a thing, it was the thing to be achieved. (Polanyi, [1944] 1957: 139)

During the period 1830 to 1850 in Britain, the enhancement of the state’s administrative functions in the form of bureaucratic control was highly needed to manage the complexity of the countless laws passed to dismantle the traditional agricultural system and to pave the way for rapidly developing industrial capitalism. In other words, the implementation of state regulation and

intervention was a precondition for laissez-faire to mushroom.

The societal implication is that market dominance is inseparable from political instrumentality as well as a conscious design. Self-regulating laissez-faire requires strong “support” from the state:

While on the one hand markets spread all over the face of the globe and the amount of goods involved grew to unbelievable proportions, on the other hand a network of measures and policies was integrated into powerful institutions designed to check the action of the market relative to labor, land, and money. (Polanyi [1944] 1957: 76)

The same applies to the forces at work in the world economy. Putting “politics in command” was not only a precondition for socialist construction as Mao put it, but was/is a prerequisite for market capitalism. In more contemporary times, the rise of American global economic power especially with regard to its boom in the 1990s had less to do with market mechanisms than with deliberate political interventions. Key macroeconomic relationships between the American economy and the international political economy came about through constant US interventions in restructuring the global market through the exercise of statecraft in a number of areas in order to favor its own economic interest. This explains the manipulation of dollar politics (exchange and interest rates), the imposition of the free movement of finance, the compulsory end of capital control in the rest of the world, beneficial terms of trade with the South, and the military control of the sources and supply of energy and raw materials (Gowan, 2001).

In the current era of global capitalism, Polanyi’s analysis deserves to be taken seriously into

consideration. The evolution of globalization cuts across different political coalitions, national bureaucracies and other domestic social institutions to ‘peg’ the state to market interests with the result that important decisions are made by corporate financial centers in North America and Western Europe. As Boyer and Drache point out,

In the 1990s, governments on both the right and left approach policy-making as a spectacular casino where everybody is trying to guess the next move of the Bundesbank, the results of the next election in Canada, Germany, the UK or France or the forthcoming statement by President Clinton on interest rates. (1996: 19)

The “invisible hand” of the market wears a political glove. It has long been held that corporate elites are just “a functional group that reproduces itself, by following the scientific laws of economics and respecting ‘good governance’”, but what is often neglected in this view is the hidden political implications that “Corporate leaders of today are involved in politics. Even if the economy remains *determinant*, politics *decides*” (Joxe, 2002: 155).

In the uneven historical development of capitalism, on which classical economists had little to say, economic nationalism offered an interpretation of international political economy, which not only recognized the imperative of statism in the promotion of industrialization strategy. The prominent political economist, Friedrich List (1789-1846), concluded from the economic history of the industrial process of Western nations such as England that there had never been such a phenomenon as unintended industrialization, free competition, or free international trade. Rather, the English example showed the opposite – the *intended* trade and market expansion

backed by *designed* protectionism of national economies and by military force if necessary:

Had they (the Britain) sanctioned the free importation into England of Indian cotton and silk goods, the English cotton and silk manufactories must of necessity soon come to a stand. India had not only the advantage of cheaper labour and raw material, but also the experience, the skill, and the practice of centuries. The effect of these advantages could not fail to tell under a system of free competition.... Accordingly, England prohibited the import of the goods dealt in by her own factories, the Indian cotton and silk fabrics. The prohibition was complete and peremptory. ([1885]1991: 42-43)

As a consequence of British industrialization strategy, the industrial revolution of India was sabotaged. In the chapter called *The Theory of the Powers of Production*, List argues that when two different countries characterized by unequal development levels maintain free trade between them, the result is that the one selling manufactured goods would be supreme while the other selling raw and agricultural products would be subservient. Only after years of protectionism, violence and imperial power, during which Britain became far ahead of any competitor, did it adopt the principles of free market with nevertheless deep reservations. Forty percent of British textiles constituted exports to India and the steel markets in the colonies were always available when the British steel price was less competitive on international markets (Chomsky, 1997).

While the Listian approach, defined as traditional economic nationalism, proved successful in the industrialization of Germany, Japan and even the United States which refused premature free trade and favoured

mercantilist state protection to promote manufacturing industries. In a similar way, the success of the East Asian newly industrializing countries in the last century was based on a path which could be called neo-Listian. From this angle, the strategic role of the state encompassed the neutralizing of domestic and external forces and harnessing them to the national project was the objective of the “developmentalist state” (Hoogvelt, 1997: 205-206). In the latter case, however, it should not be ignored that post-World War II geopolitics played a determining role in East Asia where the United States allowed non-liberal economies to emerge (Hersh, 1993 and Li, et al. 2002).

The “invisible hand” versus moral economics

It is generally recognized that what we know today about neoclassical economics is primarily derived from Adam Smith, whose book *The Wealth of Nations* (1776) is generally considered to be the intellectual underpinning for the discipline of economics. He is seen as the father of market capitalism who sketched the theory of general equilibrium whereby the pursuit of private gain can be socially productive under conditions of free competition. He is especially remembered for the notion of the *invisible hand* and the *equilibrium* thesis - the idea that the market’s competitive dynamic based on self-interest turns individual behavior into the most efficient use of resources and socially desirable outcomes.

While the “invisible hand” has become the guiding concept for neoclassical economists, it is forgotten that Smith was also professor of moral philosophy at Glasgow University whose publications included *The Theory of Moral Sentiments* (1759), which presented his views on human motivation and moral behavior. The

very first paragraph of this book could be taken as evidence of a sensitivity to social relations:

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it. Of this kind is pity or compassion, the emotion which we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrow of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous and humane, though they perhaps may feel it with the most exquisite sensibility. (Smith [1759] 2002: 11)

Is it reasonable to ascribe the interpretation that what Adam Smith wanted to bring together was the Christian ethics of “Moral Sentiments” with the acquisitive assumption of capitalist behavior of the “Wealth of Nations”? That is a combination of the individual premise of his economics with the decency of conduct undergirding social, political and economic activities, private and public. His concept of economics as a moral science, in the view of Young (1997), shows that a close relationship exists between Smith’s ethical philosophy and economics – each developing in relation to the other.

However, a more critical evaluation of Adam Smith’s contribution maintains that after having written his volume on morality (1759), his magnum opus (1776) – which only became influential a generation later – became useful to pro-capitalist forces promoting their political project with little regard to issues of morality

(Perelman, 2000: 8). In the words of a critique: “It took a professor of ethics to prise the science of Economics from the clutches of ethics – to exclude ethics from the explanation of the economic process” (Buarque, 1993: 12).

For centuries, advocates of capitalism have treated Smith’s equilibrium theory⁸ much as they have treated market theory more generally. In the view of some scholars, Smith’s ideas are distorted by self-serving corporate capitalists who selectively choose those elements of his thinking that support their objective. Schlefer (1998) argues that Adam Smith has often been misquoted and distorted in economic literature to such an extent that he is made to say things he did not mean. Others (Fitzgibbons, 1995; Korten, 1995) maintain that Smith has been misconstrued by libertarian economists and corporate capitalists. According to this line of thinking, the distortion lies in the fact that Smith’s theoretical assumptions of market economics are not the same as free-market ideology, and that his economic theory specifies a number of basic conditions needed for a market to set prices efficiently in the public interest. The greater the deviation from these public- and morality-oriented conditions, the less socially efficient the market system becomes. For Smith, any form of economic concentration would weaken the market’s natural ability to establish a price mechanism, to produce a satisfactory outcome for market interactions as well as to fairly distribute resources. It is important for society to have basic controls against such an evolution which would be detrimental to the functioning of society: “Those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments” (Smith [1776] 1937: 324).

Even though a case can be made that classical economics in its Smithian version showed more social

compassion than present-day neoliberalism, the concern for the consequences of emerging industrial capitalism was given little attention by the classics. By leaving out of the analysis the violent process of separating people from their means of existence, known as primitive accumulation, classical economics gave capitalism the needed legitimacy in the confrontation with the medieval Christian paternalistic ethic which had condemned greed, acquisitive behaviour and the urge to accumulate wealth (Perelman 2000; Hunt and Sherman 1981: 30)

In the current era of globalization, the rise and dominance of corporate capitalism resulting in concentration of wealth (Anderson and Cavanagh, 2000), increasing inequalities, and global environmental crises indicates that the gap between moral ethics and economics is enlarging. A remarkable mismatch can be observed between on the one hand modern economics' emphasis on competition, productivity, efficiency, free market and on the other hand moral, religious and ethical frameworks of social justice, collective values as well as human development. The market does not generate and accumulate "moral capitals"; on the contrary, it depletes society of them. It reduces people to servants of the economy rather than have the economy serve the people. The nature of economics in the eyes of Amartya Sen "has been substantially impoverished by the distance that has grown between economics and ethics" (1987: 7).

The evolution of market capitalism can be seen as having gone through a number of deformation stages: 1) from cultural and religious reformation to a modified form of moral and ethical system that is detached from the original moral ethics; 2) from "society with market" (moral economics) to "market society" (value-free economics); 3) from theological and spiritual salvation (faith in God) to a misguided type of secularism (faith in the market). Such an evolution is not an unanticipated process;

rather, it can be identified as embedded within the political economy of capitalism.

When the effect of the deformed transformation reaches its highest level, a new type of belief system emerges – the religion of market capitalism with the *market* as the deity that implicitly promises to alleviate global sufferings through economic development. The key difference between the old religion and the new one is that the former adhered to values defined and observed by the Church, i.e. human beings as moral and ontological creatures; whereas in the latter, people become commodities and consumers interacting in the value-free market, i.e. humans as tradable things and objects. Ironically, rational reason, which broke the theological myth and helped capitalism flourish, is elevated to a holy faith in capitalism, demanding complete obedience and disregard of other interpretations. This new secular religion is coined by Thomas Frank as "market populism" (2000).

The central theme II: An anticipated war of political struggles

The case can be made that the main distinguishing characteristic of the 20th century has been the endless struggles between people and nations whose devotion to ideological paradigms or systems of political ideas was regarded as unacceptable to others. Political concepts, such as socialism, democracy, conservatism, neoliberalism, realism, globalism and so forth involved political, economic, and psychological struggles for universal acceptance.

Since the 1920s when capitalism suffered the Great Depression and during the crises in the 1970s, supporters of the capitalist system were on the defensive. This was partly due to the contrast of the rapid economic growth of the Soviet Union until the

1970s as well as its military and technological expansion. The impressive performance displayed by the economy of USSR aroused fears in Western political classes that the socialist development model might attain ideological significance in the non-socialist world. In addition, the Chinese development strategy based on self-reliance was likewise recognized as another potential rising force. In the prevailing mood of the time, neoliberalism, which considered socialist and nationalist movements as anti-systemic to the capitalist world system, occupied little space in the mainstream intellectual frame. The so-called anti-systemic forces included the socialist countries, the national liberation movements, and the coming to power of social-democratic and labour parties in the Western world. It was fashionable at the time for governments of capitalist countries to identify themselves as either Keynesian or Social Democratic.

The transformation of ideological hegemony from proto-socialist and pro-labour systems of welfare states to individualistic capitalism, under the current impact of global capitalism, was not an automatic process. It entailed decades-long ideological and political struggles between contending forces. Adherents of neoliberalism realized as early as the immediate post-World War II period that in order to fundamentally transform political, economic and social ideologies they had to prepare for time-consuming and gradual changes of intellectual and psychological convictions. With the end of the Cold War neoliberalism is claimed by its adherents to be the only legitimate system of ideas. But this was not the outcome of a process left to chance. The inherent shortcomings of state socialism as well as the financial and economic difficulties of the welfare states together with the debt crisis in the Third World were encouraging signals for the offensive of neoliberalism. But its victory is the result of a half century's ideological efforts to penetrate the realms

of politics, economics and various international organizations. The alliance of financially strong interest groups with academics and intellectuals nurtured in American thinktanks was able to transform the agenda within economic and political thinking and decision-making in the course of decades (George, 1997).

While accusing socialist experiments of totalitarianism and ideological indoctrination, neoliberals have taken the proposition for granted that *ideas* must penetrate into people's mind through all possible means, i.e. education, press, media, and international institutions. This strategy recognizes the force of ideology behind social transformation since human beings are not born with neoliberal thinking. In order for certain ideas to receive greater attention and publicity, they must be promoted through financial support so as to build a strong intellectual superstructure. The goal of building such a framework is to nurture a liberal worldview: the conceptualization of capitalism as an indispensable condition for political liberty. A solid intellectual infrastructure of neoliberal ideas corresponds to what Gramsci (1971) considered to be part of capitalism's "hegemonic project," that is the power and ability to define, sustain, and control ideas in order to "get into people's heads and ...acquire their hearts, their hands and their destinies" (George op.cit.: 51).

The Fall of the Berlin Wall was perhaps the "greatest victory" for partisans of neoliberalism who believe in the slogan - *Ideas Have Consequences*, the 1948-book by one of the American founding fathers of neoliberalism, Richard Weaver. Likewise, Thatcherism and Reaganism, as the political protagonists of neoliberalism, can be seen as having proved that ideas like actions do have consequences in a specific context of neutralizing counter-movements. One of the on-going outcomes is the trend toward the formation of an ideal-type neoliberal world that we are witnessing today: the globalization of

the world market, technology, finance, and culture. Rapid integration and uniformity that bind the world together through fast food, pop music, high-tech computers are pressing nations into a commercially homogenous global structure. In every part of the world, national identities and sovereignties are eroding giving rise to global entities – multinational companies and transnational banks. The ideological compulsion to create an international market, which in turn requires a common belief, common language, common policies, and common currency, is at the same time creating a global cosmopolitan city-life style based on one commonality – American Express and Visa Card.

When the claim is made that we have entered a new era of globalization featured by “information technology” and “free market,” these catchy terms are not just language reflections of reality, but represent the strong ideological bias of liberalism which has been carefully nurtured by those who stand to gain from its rule. The collapse of the European and Asian communist systems has led liberal politicians, economists and journalists to display a zero-sum game logic in the analysis of the ideological dichotomy: if communism does not work, then it must be replaced by capitalism; if socialist planned economies fail, then liberal free-market economies must be universally accepted. These simple binary oppositions in which Communism is contrasted to free market, authoritarianism to democracy, dictatorship to freedom have become “universal criteria” of world politics and economics. However, given the absence of any viable social alternative, the hidden nature of market economics will from now on be analyzed and assessed on the basis of its own merits/demerits

Conclusion

In this paper, we have attempted to offer a framework for understanding the birth and expansion of capitalism, which has a different analytical focus than the mono-causal explanation that rely on culture, technology and economics. In our view, the shortcoming of these approaches is that their explanations are basically constructed around the proposition that the origin and development of capitalism is an fortuitous consequence of an aggregation of series of mutually-supportive activities. Viewed from this optic, capitalism emerged within a specific socio-cultural setting and developed out of a long process of competitive activities of merchants and manufacturers in the rational pursuit of their individual economic self-interest, which evolved in the development of new production relations and eroded the existing structure of society. However, although acknowledging its significance, we reject this conventional wisdom and emphasize what is usually not debated – the *political essence* and *content* behind the “evolution” of capitalism. To paraphrase Karl Marx, if the appearance of a phenomenon revealed its essence, there would be no need for scientific inquiry.

The entire history of capitalism is one of a forced process of inclusiveness and exclusiveness. Its starting point was the imposition of a ruthless coercion on common people through the compulsory enclosure and enforced formation of new property relations and legal system. With the restrictive access to land accompanying industrial transformation began a new form of production relations based on primitive capitalist accumulation. Simultaneously, Europe’s expansion overseas, which began with conquest and trading relationships, resulted in the extension of the capitalist system of production. Through the slave trade, colonialization, “free trade”, world wars, foreign aids,

structural adjustment, etc., the division of world resources and international division of labor was imposed and extended by military and political means. These aspects in the history of capitalism are outside the purview of conventional economics as well as the culturalist analysis.

The same process is still at work in many parts of the world. In developing countries many peasants are being press-ganged into factories as capitalism is forcibly imposed on them. The transition of non-capitalist society into market capitalism is not the choice of the people nor is it generated by the market necessities, rather, it is implemented by the elites of these countries with the support and encouragement of global capitalist forces and installations and on the basis of their political and economic interests. China's societal development in the past decades is a case in point.

It is no exaggeration to conclude that in historical retrospect and in the predictable future following the consequence of the radicalization and universalization of market capitalism, major issues concerning human society, such as development, globalization, North-South divide, inequality, poverty, security, welfare, trade, terrorism, war, etc., are and will be bounded within political foundations. Under these circumstances, politics is the most important arena where solutions of societal contradictions as well as sources of human struggles are to be found.

Endnotes

¹ One of the points of reference for this article is the discussion of the religiosity of capitalist market and economics, which tends to rely on extra-scientific theorems with mystical assumptions. For a satirical perspective of this approach, please refer to the piece of

“biblical story” of the holy creation process – the prophet, the prophecies, and the tenets the God’s words – the *natural law* of economics (Madjd-Sadjadi, 2004).

² In Kuhn’s explanation paradigms are social and intellectual constructs, system of explanations and interpretations by which natural scientists/social scientists attempt to make sense of the real world. When the old paradigm begins to be confronted by anomalies, a new paradigm starts to emerge and struggles to consider and interpret the same evidence in a new light, thus opening novel avenues for accumulating additional knowledge.

³ Within the Western Christian religion there was a long struggle between the Protestant Reformation and the Catholic Counter-Reformation in pre-modern Europe where the leading powers were divided along religious lines: Catholic, Protestant, Eastern Orthodox and Muslim. The Wars of Religion (1618-1648) ended with the Peace of Westphalia. Among these powers, the Protestant (first England and the Netherlands and later the United States) had distinctive secular characters which were analyzed by Max Weber who in *The Protestant Ethic and the Spirit of Capitalism* developed a culturalist explanation as to why capitalism originated in the Protestant part of Europe.

⁴ A religious movement in 16th-century Europe that took place as an attempt to reform the Roman Catholic Church and ended with the establishment of independent Protestant Churches.

⁵ In Weber’s understanding, the spirit of capitalism in the West became a moral and ethical system stressing economic success, whereas, material greed and profit-making were viewed as ethically immoral in many non-Western cultures as well as pre-protestant Europe.

⁶ It should not be forgotten that in order for capitalism to flourish in North America and Australia, forced

population transfers of the destitute from Europe took place in order to colonize these areas, thus giving these entrepreneurs the needed labor power for their economic activities while releasing population pressures in the metropolises.

⁷ Friedrich Hegel, in comparing Western consciousness with that of the rest of the world which created revolutionary history, placed China in the “childhood” phase of history; and Karl Marx, whose theories and insights inspired the Chinese Revolution, described China in some articles for the New York Herald Tribune as a society “vegetating in the teeth of time”, and characterized the Great Wall of China as a metaphor for the universal resistance of non-European societies to change. See Dirlik and Meisner (1989:17).

⁸ Equilibrium refers to an ideal market-price situation in which the interactions of economic agents are mutually consistent. Taking commodity price for example, equilibrium of price is shaped by a mutual affecting process in which suppliers increase prices when demand is in excess and decrease them when supply is in excess - the mechanism regulates the forces of supply and demand. See Begg, David, et. al (2000:30-32).

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