

International Political
Economy in Context:
Individual Choices,
Global Effects

To Pam, Donna, and Amy

International Political Economy in Context: Individual Choices, Global Effects

Andrew C. Sobel



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Brief Contents

Figures, Tables, and Maps	xviii
Preface	xxi

PART I. BUILDING BLOCKS TO EXAMINE GLOBAL POLITICAL ECONOMY AND CONFLICT

1. Introduction: Political Economy, Rationality, and Social Science	3
2. Structure, Nation-States, Power, and Order in an International Context	54
3. Economic Liberalism and Market Exchange in the Global Arena	112

PART II. MICRO TOOLS

4. The Micro Approach to Political and Economic Markets in Theory and Practice	149
5. The Dilemma of Collective Action: Who Organizes, Who Does Not, and Why	202
6. The Role of Hegemonic Leadership and Its Micro Foundations	221
7. Interest Groups and International Economic Foundations of Political Cleavage	251
8. The Role of Institutions in Political and Economic Market Failure	277

PART III. CONTEXT

9. Around the World in Eighty Days: A Stage of Modern Globalization	317
10. The World between the Wars: A Breakdown in Globalization	367
11. The Bretton Woods System: The Rebuilding of Globalization	415
12. The World Post-Bretton Woods: Globalization Advances	464
13. Détente and the End of the Cold War: Globalization during Transition	511
14. Into the Future: Political and Economic Market Failures and Threats to Globalization	533

Index	567
Photo Credits	593
About the Author	595

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Detailed Contents

Figures, Tables, and Maps	xviii
Preface	xxi

PART I. BUILDING BLOCKS TO EXAMINE GLOBAL POLITICAL ECONOMY AND CONFLICT

1. Introduction: Political Economy, Rationality, and Social Science	3
Similarities across Domestic and International Politics	4
Globalization and Global Capitalism: Connecting Markets and Communities	5
The Past as Prologue	9
What Is Political Economy?	10
Three Core Assumptions within the Micro Political Economy Approach	11
Scarcity	12
Political Survival	14
Rationality	14
Rationality, Preferences, and Self-Interest Explored	15
Ordering Preferences	15
Rationality under Scarcity and Political Survival	16
Two Properties of Preference Ordering: Completeness and Transitivity	17
Context and the Interdependence of Choices:	
Opportunity for Strategic Behavior	20
Game Theory: Modeling Context and Interdependent Choices	21
Outcomes versus Choice: Using the Rationality Assumption	24
Backward Induction	25
An Example of Backward Induction	26
The Purpose and Process of Social Science	28
Social Analysis as Social Science	28
Tasks of Inquiry: Describing and Explaining What Happened and Why	33
Two Examples of Theoretical Failures: Liberalism and Realism	35
Liberalism: The Mutually Beneficial Exchange of Trade and Globalization	36
Realism: The Nation-State System and the Distribution of Power	40
Conclusion and Some Other Pitfalls	46

Appendix: Examples of Complete and Intransitive Preferences	47
Key Concepts	50
Exercises	51
Further Reading	53
2. Structure, Nation-States, Power, and Order in an International Context	54
The Context of International versus Domestic Political Arenas	55
Nation-States: Influential Political Organizations	
in the Global Arena	55
States and Their Defining Characteristics	56
Functional Equality and Specialization: What Every State Does, but Some Better than Others	57
Nation: Development of Collective Identity and Social Cooperation	61
Origins of the State System: Empire and Fragmentation	70
The Treaty of Westphalia and Sovereignty:	
Redrawing the Lines of Political Authority	74
The Principle and the Practice of Sovereignty	76
Common Violations of the Principle of Sovereignty	77
Anarchy: Conflict, Competition, and Cooperation	
in the Global Arena	78
Self-Help Dispute Resolution under Anarchy	79
Hierarchy: Looking for Order and Predictability	80
Power Defined as a Relative Concept	81
Using the Tools of Statecraft and Diplomacy to	
Influence Behavior	82
Persuasion	83
Offer of Rewards	83
Granting of Rewards	83
Threat of Punishment	84
Nonviolent Punishment	85
Force	86
Analyzing Political Behavior: Weighing the Costs	
and Benefits of the Tools of Statecraft	87
Finding Order in Anarchy: Power Capabilities and Attributes	89
Motivation versus Capability in the Hierarchy of Influence	89
Tangible Attributes That Contribute to Power	90
Intangible Attributes That Contribute to Power	97
Conclusion	106
Key Concepts	108
Exercises	108
Further Reading	111

3. Economic Liberalism and Market Exchange in the Global Arena	112
Economic Liberalism: Competitive Markets and Social Outcomes	113
The Price Mechanism Coordinating Supply and Demand	114
Factors of Production: The Allocation of Land, Labor, and Capital	115
The Normative Appeal of Economic Liberalism:	
Individual Choice, Liberty, and Efficiency	117
Market Exchange as the Basis of International Trade:	
Mechanisms at the Core of Modern Globalization	119
Absolute Advantage: An Early Principle of International Trade	121
Comparative Advantage: A Revolution in Thought	122
Revisiting Factors of Production: Labor Theory of Value to Factor Endowment	126
The Balance of Payments: Regulating Trade and Capital Flows in the Global Political Economy	129
The Role of Financial Invention and Integration in Expanding Global Capitalism	133
Money: A Functional Approach	134
Expanding Access to a Larger Pool of Capital	137
Labor Mobility: Creating Linkages across State Borders	139
Conclusion	141
Key Concepts	144
Exercises	144
Further Reading	145

PART II. MICRO TOOLS

4. The Micro Approach to Political and Economic Markets in Theory and Practice	149
Individual Preferences, Social Outcomes	149
Economic and Political Market Exchange	150
Market Exchange in the Political Arena:	
Rational Consumers and Producers	152
The Mechanism of Political Exchange	153
Voluntary versus Nonvoluntary Exchange	154
Social Choice and Voting Rules	156
Theoretical Prerequisites of Efficient and Competitive Markets	157
Clear Property Rights and Low Transaction Costs	159
Competition and Manipulation of Market Exchange	161
Externalities	165
Complete Information	168

An Example of Political Market Exchange: Elections, the Median Voter, and Selection of Policy	175
International Affairs If the Conditions for Efficient Economic and Political Exchange Hold	181
Market Failure and Suboptimal Social Outcomes	182
Understanding Market Failure	183
Incomplete Property Rights and Nonnegligible Transaction Costs	183
Manipulation of Supply and Demand	184
Third-Party Negative and Positive Externalities	186
Threats of Incomplete and Asymmetric Information	188
Context and Social Traps: Cycling, Coordination, and Cooperation Problems	190
Conclusion	194
Appendix: Using Game Theory to Explore Cycling and Coordination Problems	196
Key Concepts	199
Exercises	199
Further Reading	200
5. The Dilemma of Collective Action: Who Organizes, Who Does Not, and Why	202
A Paradox of Collective Action	203
Dismantling the Social Trap: Self-Interest and Collective Outcomes	204
What Is a Collective Good?	205
Initial Expectations about Provision of Collective Goods	206
Positive Externalities and Incentives to Free Ride	206
The Unraveling of Collective Good Provision	207
Another Paradox: Collective Action despite the Social Trap	208
Mechanisms for Overcoming Barriers to Collective Action	209
Compulsion	209
Selective Incentives	211
Entrepreneurship	213
Piggybacking	214
Group Size	215
Some Other Collective Action Considerations	218
Conclusion	219
Key Concepts	219
Exercises	219
Further Reading	220

6. The Role of Hegemonic Leadership and Its Micro Foundations	221
Growing Global Exchange under a Liberal Hegemon	221
Hegemonic Leadership and Global Stability	223
Liberal Hegemons and Important Collective Goods	225
Open Market for Distress Goods	225
Countercyclical Lending	226
Stable Exchange-Rate System	227
Macroeconomic Policy Coordination	228
Lender of Last Resort: Managing Liquidity in the Global System	229
Sources of Hegemonic Capacity: Arising from	
Challenges to Political Survival	230
Public Finance and Hegemonic Provision of Collective Goods	231
Rule of Law	232
Taxation	233
Public Debt	234
Lender of Last Resort	235
National Currency as an International Reserve Currency	237
Private Finance and Hegemonic Provision of Collective Goods	238
Capital Market Size	238
Capital Market Diversification	239
Capital Market Depth and Liquidity	239
Market Transparency and Clearinghouse Mechanisms	240
Openness and Absence of National Bias	240
Change and Development of Hegemonic	
Capacity in a Global Financial Network	241
Credibility of Public and Private Financial Arrangements	
in the Global Political Economy	242
Increasing Returns and Network Externalities Necessary	
to Become a Global Capital Financial Center	243
Alternative Explanations of the Source of Hegemonic Leadership	244
Conclusion	248
Important Caveat	249
Key Concepts	249
Exercises	249
Further Reading	250
7. Interest Groups and International Economic Foundations	
of Political Cleavage	251
A Puzzle: How to Anticipate Possible Cleavages and	
Coalitions in Political Economies	252
Explanations Grounded in Micro Political Economy	254

Interest Groups: Fragmenting Monolithic Perceptions of Society	255
Biological and Social Foundations of Cleavage	256
International Economic Sources of Cleavage	258
Factor Endowment: A Source of Preferences, Cleavage, and Coalition	259
A Critique of the Factor Endowment Framework	269
Industrial Sector as an Alternative Means of Interest Aggregation	272
Asset Characteristics as an Alternative Means of Interest Aggregation	273
Conclusion	275
Key Concepts	275
Exercises	275
Further Reading	276
8. The Role of Institutions in Political and Economic Market Failure	277
Constraining Social Traps and Market Failure	277
Institutions as Rules of the Game: Influencing Actions and Outcomes	280
Difference between Formal and Informal Institutions	281
Institutions as Social Bargains and <i>Ex Ante</i> Agreements	283
Institutions as Equilibria	285
Institutions as Incentives and Path Dependence	286
A Normative Caveat: Are Institutions Inherently Good?	286
Institutional Effectiveness and Durability: Lasting Consequences	287
Distributional Implications of Institutions	293
The Social Origins of Institutions: Intentional and Unintentional Design	295
Institutions as Devices to Overcome the Time-Inconsistency Dilemma	296
Important Institutional Considerations in Domestic and Global Affairs	298
Regime Type: Democratic and Authoritarian Regimes and the Rules of the Game	299
Electoral Systems: Influencing the Nature of Politics and Policies	301
Structure of Government: Domestic and Global Implications	303
Social Institutions: Influencing Uncertainty and Risk through Social Bargains	308
Veto Points: Institutional Checks and Balances in a Political Economy	310
Conclusion	312
Key Concepts	312
Exercises	312
Further Reading	313
 PART III. CONTEXT	
9. Around the World in Eighty Days: A Stage of Modern Globalization	317
Globalization Is Nothing New	318
Intellectual Change: Comparative Advantage and Efficiency Improve Social Welfare	320

Shifts in Public Policy Affect International Exchange	321
Mercantilism and Protectionism as the Legacy of War	321
The Rise of British Protrade Political and Policy Pressures	323
Bilateral Trade Treaties and Most-Favored-Nation Status	326
Other Liberalizing Policy Shifts and a Caveat	327
The Influences of Risk and Uncertainty on International Trade	328
Managing Risk and Uncertainty: Incomplete Contracting, Default Risk, and Banker's Acceptances	328
Managing the Problems of Currency Risk: Monetary Regimes	330
The Gold Standard and Stable Exchange Rates	332
Debate over Alternatives to the Gold Standard	334
Why Converge on a Gold Standard?	337
Convertibility as a Collective Good	339
Why Would a Government Renege on a Commitment to Its Currency Price?	340
British Contributions to Other Collective Goods	342
Liquidity: Fuel for a Global Economy	342
Lender of Last Resort: Managing Economic Crises	344
Market Access under Duress	347
Technology's Role in the Growth of Globalization	348
Transportation Leads to Greater Efficiency and Market Integration	349
The Industrial Revolution and Migration Transform Political Economies	353
Technological Advances in Communication Promote Globalization	354
The Dark Side of Globalization in the 1800s	358
Creative Destruction and Dislocation	359
The Dominance of Colonialism and Imperialism	360
Conclusion	363
Key Concepts	364
Exercises	364
Further Reading	365
10. The World between the Wars: A Breakdown in Globalization	367
Why the Reversal in Globalization and Economic Advance?	367
Allocating Costs of Adjustment	369
The Legacy of Rapid Change in the 1800s	370
Agriculture and Costs of Adjustment	371
Retrenchment of Trade Barriers	372
The Unsettling Legacy of World War I in the Interwar Years	373
Post-World War I Population Loss as a Barrier to Economic Activity	374

The Exchange-Rate Mechanism: Currency Instability and Convertibility	376
Beggars-Thy-Neighbor Policies and Currency Devaluation	382
Breakdown in Liquidity and Lender-of-Last-Resort Collective Goods	383
The Effects of War Debts and Reparations on Liquidity	384
German Hyperinflation Threatens Monetary and Political Stability	387
The Rise of Political Extremism in Germany	389
U.S. Financial Market Speculation and the Crash	391
Crisis in the Credit Mechanism	393
The Breakdown in Trade Erodes the Benefits of Global Exchange	399
Tit-for-Tat Retaliation Beggars International	
Trading Partners and Hinders Recovery	402
The Absence of Hegemonic Leadership in the International System	404
Conclusion	411
Key Concepts	411
Exercises	412
Further Reading	413
11. The Bretton Woods System: The Rebuilding of Globalization	415
Past Mistakes and a New Framework for International Cooperation	416
Policy Making and Time Inconsistency:	
Lessons from the Interwar Years and the Postwar Dilemma	418
Using Monetary and Fiscal Policies to Manage Economies:	
Postwar Domestic Strategy and Mechanism Design	421
Supporting Hegemonic Leadership with IGOs:	
Postwar International Strategy and Mechanism Design	424
Promoting Freer Trade: The GATT	425
Monetary Arrangements and the International Monetary Fund	433
Development and the World Bank:	
Encouraging Economic Expansion	440
Active Engagement and the Truman Doctrine	447
Economic and Military Containment	448
The Marshall Plan's Strategy to Promote Economic Growth	449
Breakdown in the Bretton Woods Monetary Arrangements	451
Suspension of Convertibility and Imposition of Capital Controls	452
The Leading Currency Problem and the Triffin Dilemma	452
Growing Pressures on the Dollar-Gold Relationship	
Threaten the Bretton Woods Monetary System	455
U.S. Financial Constraints and International Reactions Challenge	
U.S. Leadership	456
Suspension of Dollar-Gold Convertibility	459

Conclusion	461
Key Concepts	462
Exercises	462
Further Reading	463
12. The World Post–Bretton Woods: Globalization Advances	464
Fundamental Shifts in Global Finance	465
Post–Bretton Woods Monetary Arrangements	466
Seeking a Stable System of Exchange Rates amid a Variety of Exchange-Rate Mechanisms	468
Strategies to Limit Exchange-Rate Volatility: Currency Pegs, Currency Control Boards, and Limited Monetary Policy Flexibility	471
A Collective-Currency Peg to Limit Exchange-Rate Volatility: The European Snake	473
Balancing Strong- and Weak-Currency States: The European Monetary System	475
The European Monetary Union: Balancing Greater Monetary Integration with Fiscal Autonomy	477
Financial Globalization and Liberalization: Unleashing National Financial Markets and Reviving Global Finance	483
Explanations for Globalization: Technology, Competition, Politics, and Policy	489
Challenging the Emerging Global Financial Infrastructure: Petrodollars and a Debt Crisis	494
Implications of Financial Globalization: Does Mobile Capital Gain Disproportionate Advantage and Erode National Policy Autonomy?	497
The Capital Mobility Hypothesis: The Use or Fear of Bargaining Leverage	499
The Unholy Trinity: Three Policy Tools and an Inherent Tension	500
Going Forward: The IMF and the Washington Consensus	502
Conclusion	507
Key Concepts	508
Exercises	508
Further Reading	509
13. Détente and the End of the Cold War:	
Globalization during Transition	511
Cold War to Post–Cold War Transformation	511
The Command Economies Gradually Join the Global Economy	512

Détente and Shifts in the International Political-Military Context Lead to Improved Economic Relations	513
The Cuban Crisis and a U.S.-Soviet Strategic Gap Lead to Greater Cooperation	514
The Two Germanys and Political Settlement in Europe Transform the Global Context	515
The Vietnam War's Resolution Contributes to Improved East-West Relations	518
Global Implications of Discord within the Sino-Soviet Alliance	520
Domestic Shifts in the Eastern Bloc and China Generate Greater International Exchange	522
Access to Western Markets, Technology, and Capital Encourages Development	523
Second Thoughts, Overleveraged Political Economies, and International Lending	524
Renewal of Political-Military Tensions Interrupts the Eastern Bloc's Global Economic Integration	525
China Takes Steps toward Liberalization	526
Arms Control, Perestroika, and Glasnost Change the Political Economic Landscape	526
Conclusion	528
Key Concepts	531
Exercises	531
Further Reading	532
14. Into the Future: Political and Economic Market Failures and Threats to Globalization	533
Regional and Financial Instability Grow into a Systemic Threat	534
The Future of U.S. Leadership in the Twenty-First Century	536
A Network of Financial Relations Creates Self-Sustaining, but Not Stable, Leadership	538
Public and Private Domestic Financial Practices Threaten U.S. Hegemony	539
Challenging the Health and Efficacy of U.S. Global Economic Leadership	542
Potential Hegemonic Successors to Stabilize the System and Promote Cooperation	544
Considering the Microfoundations of Hegemonic Capacity for China, India, and the European Union	545

Conclusion	562
Key Concepts	565
Exercises	565
Further Reading	565
Index	567
Photo Credits	593
About the Author	595

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Introduction: Political Economy, Rationality, and Social Science

This book adopts a political economy approach to examining world affairs in an era of expanding globalization. In this chapter we begin to build a foundation for this approach. First, we define what we mean by *globalization*, then we introduce the basic framework of political economy, and finally we consider what it means to poke and prod social behavior as social scientists. Before we go into greater depth, what is political economy? Moreover, what is international political economy and how does it differ from just plain political economy?

Political economy refers to a specific theoretical approach that focuses on the rational calculations and choices of individuals, and how those choices interact to produce social outcomes in world affairs. What makes this book's approach different from a political economy approach to domestic politics is the added consideration that such choices and aggregation processes occur in settings, and with consequences, that span national boundaries. From a political economy perspective, the logic of decision making in both domestic and world affairs is the same. The context,

I consider that a man's brain originally is like a little empty attic, and you have to stock it with such furniture as you choose. A fool takes in all the lumber of every sort that he comes across, so that the knowledge which might be useful to him gets crowded out, or at best jumbled up with a lot of other things, so that he has difficulty in laying his hands upon it. Now the skillful workman is very careful indeed as to what he takes into his brain-attic. He will have nothing but the tools which may help him in doing his work, but of those he has an assortment, and all in the most perfect order. It is a mistake to think that little room has elastic walls and can distend to any extent. Depend upon it there comes a time when for every addition of knowledge you forget something that you knew before. It is of the highest importance, therefore, not to have useless facts elbowing out the useful ones.

—*Sherlock Holmes*, in *Arthur Conan Doyle, A Study in Scarlet*, 1887

Political economy encompasses a variety of approaches to social behavior. Macro political economy investigates associations between political activities and substantive performance of an economy. A micro political economy approach focuses on the processes that influence, motivate, and constrain the choices of individual political actors. In this micro approach to political economy we seek to examine the processes of choice that lead to government policies and to social, economic, and political outcomes. This approach seeks to investigate and construct the microfoundations of macro outcomes. A micro political economy approach can be used to examine individual decisions and social outcomes across a wide variety of settings. In this book, it is applied to questions in the arena of international affairs, international cooperation, and globalization.

however, differs in important ways that have profound implications for arriving at productive or damaging social outcomes. The implications of the important differences in structure and context that separate domestic from international affairs are what set this book's approach apart from a straight political economy focus and will become more explicit and apparent later in this chapter and the next.

SIMILARITIES ACROSS DOMESTIC AND INTERNATIONAL POLITICS

Many in political science separate the study of international relations from international political economy, applying distinctions such as the “high politics” of security versus the “low politics” of economic relations. They also separate the study of domestic politics from international politics. These

distinctions are misleading and intellectually damaging. Political scientists look for explanations and processes that generalize from one setting to others. This is one characteristic that makes political science a science. If man is “a political animal,” we should establish what we mean by *political* and how the mechanisms of politics work. The theories and explanations that help us make sense of political behavior are likely to be similar across domestic and international arenas and across issue areas, whether security, economic, or social. The key difference will be in the dependent variable, or what we seek to explain, and not in the independent variables—the mechanisms and explanations of why political actors do what they do. Separating the study of security and conflict from the study of economic relations in the global arena, or from the study of domestic politics, suggests that politics works completely differently in one sphere than in another. Others have made this dichotomy and suffered serious consequences. In the 1500s, Philip II of the Spanish Habsburg Empire, a military superpower of its time, sought to quell a rebellion against Spanish rule by the provinces of the Dutch Netherlands, a far smaller political and demographic entity. Napoleon, a warrior, dismissed England as a “nation of shopkeepers,” and Mao Zedong (“All power comes from the barrel of a gun”) called the United States a “paper tiger.” The Dutch, the shopkeepers, and the paper tiger prevailed in the political-military sphere because of their activities and capabilities in the political economic arena. The Dutch Netherlands, the United Kingdom, and the United States dominated international affairs during the 1500–1600s, 1700–1800s, and 1900s onward, respectively, becoming hegemony through the strength of their economies and the policy choices they made in their domestic political economic arenas. The Soviet

Union amassed an impressive military but lost the Cold War and disintegrated because of its inability to compete with the economic prowess of the U.S. political economy. Success in political economic affairs spills over to the security sphere. Creating a false dichotomy between substantive spheres of political activity and neglecting connections across them is therefore dangerous not only in terms of our understanding of political behavior but also in terms of policy.

Let's start by examining the broad and shifting structure of world affairs, which is characterized by capitalism and an increasing globalization of social, political, economic, and cultural relations across national boundaries. This increasing globalization of human interactions across national boundaries presents national policy makers, public and private, with tremendous opportunities to enhance the well-being of their societies and communities, but it also creates pitfalls and challenges that, if poorly addressed, could damage and undermine that well-being. A political economy approach to world affairs will help us recognize those opportunities and challenges, enabling us to understand why societies sometimes act productively and sometimes perversely in terms of aggregate social welfare, and, for those of us interested in improving social outcomes, may provide a road map that will allow us to avoid potholes in our journey through life.

GLOBALIZATION AND GLOBAL CAPITALISM: CONNECTING MARKETS AND COMMUNITIES

Global relations of various kinds play a growing and important role in our day-to-day lives. Economic, social, cultural, and political relations within and across nations have shifted dramatically over the past two centuries, and they continue to change at a rapid rate. These transformations contribute to the process called **globalization**, which affects social relations between and within

nation-states. Globalization consists of the multiple processes by which people in one society become culturally, economically, politically, strategically, and ecologically closer to peoples in geographically distant societies. These processes include the expansion of cross-border trade, the production of goods and services through multinational corporations, the movement of peoples, the exchange of ideas and popular culture, the flow of environmental degradation and disease from one nation to another, and the routine transfer of billions of dollars across borders in nanoseconds. They connect communities, cultures, national markets for goods and services, and national markets for labor and capital. The food we consume, the clothes we wear, the jobs we perform, the air we breathe and the water we drink, the cars we drive, the transport that delivers our goods, the information we access, the capital that powers our economies, the services and computers we use, the places we travel to, the education we seek, the diseases we contract, and just about every aspect of our day-to-day

Globalization consists of the processes by which people in one society become culturally, economically, politically, strategically, and ecologically closer to peoples in geographically distant societies.

lives have some international component. This book seeks to help students develop the tools they need to understand why policy makers, public and private, make the choices they do in an era of increasing globalization.

One characteristic of globalization is the prospect for some incidence of convergence across nations as markets and societies become increasingly exposed to each other and increasingly integrated. The more integrated economies become, the more closely we should observe prices for commodities and labor across those economies converging. Still, there is little reason to expect complete—or even near—convergence in many arenas of social life. A continued divergence in commodity and labor prices across markets demonstrates the persistence and stickiness of distinct national political economies in the face of globalizing pressures. Moreover, the services that states provide to their citizens can vary quite dramatically from state to state. Such differences represent differences in social contracts—the bargains between governments and their peoples. The modern nation-state is far from dead or from being brushed aside by the trend toward globalization.

One factor that has contributed to economic convergence is the advance of **global capitalism**, which is a particular form of social and economic relations connecting national economies. After the collapse of the communist regimes of the Eastern bloc in the late twentieth century, capitalism emerged as the preeminent form of social and economic organization in the global political economy. In global capitalism, exchange across nations occurs primarily in markets, where consumption choices are voluntary, determined by supply and demand, and coordinated by price mechanisms. Markets can be located in physical structures

Global capitalism is a particular form of social and economic relations connecting national economies, by which exchange across nations occurs primarily in markets, where consumption choices are voluntary, determined by supply and demand, and coordinated by price mechanisms. **Decentralized** economic systems are those in which consumption, production, and allocation choices are voluntary, determined by supply and demand, and coordinated by price mechanisms. **Centralized means of allocation** are distribution mechanisms that are more hierarchical and authoritative than the voluntary, consensual nature of a market.

such as buildings, on docks, in town squares, or in cyberspace, where exchanges are conducted via computer keystroke. Markets are wherever merchants and consumers gather to exchange commodities and services.

Markets aggregate individual activities and produce collective outcomes. They are relatively **decentralized** mechanisms for allocating goods, capital, and services within and across societies. This mode of exchange differs from more **centralized means of allocation** such as government-administered distribution mechanisms that are more hierarchical and authoritative than the voluntary, consensual nature of a market. In this book, we extend the framework of market exchange beyond the boundaries of economic exchange to encompass political exchange as

well. When economic and political markets work well, they are a wonderful means of aggregating individual preferences, conveying tremendous amounts of information, and producing collective outcomes. They tell us about the preferences of consumers and voters in society,

about the productive capabilities of producers and policy makers given the distribution of resources in society, and about the most efficient ways to coordinate the choices of consumers and voters with those of producers and policy makers.

The expansion of globalization means that economic production and consumption choices in one nation are increasingly influenced by similar choices in other nations. For many years, economists used **closed-economy models** to examine economic conditions in a society. They ignored economic factors and conditions external to a nation, thinking about the nation's economy as if it were a secluded island. But with the transformation of national capitalist relations into increasingly global capitalist relations, closed-economy frameworks have given way to **open-economy models**, in which connections across national economies are considered to be important factors in a nation's economic and social welfare and the politics that surround it. Imports and exports now constitute at least a third of the economies of advanced industrialized nations, and for many, such as Germany, the size of the tradable sector is even larger.

The extent of global influence on our lives may vary depending upon where we live, our nationality, our income, our profession, and the openness and strength of our national political economy. However, the world is figuratively shrinking, as activities in one nation spill over to influence activities in other nations with greater and greater frequency. Almost certainly, the connection of economic markets across borders will influence choices and actions in national political markets. The shifts in global economic activity spawn debates about the changing roles of markets and states, about the risks individuals face in this changing state of affairs, and about whether those risks can or should be managed and, if so, by whom. At the heart of these debates rests an extraordinary tension between economic and political forms of social organization. Global capitalism is based on market exchange and an economic geography that spans national borders. With globalization, economic relations are increasingly formed and shaped by global market forces. In theory, these forces do not recognize the political boundaries of nation-states, yet national borders define political arenas and are the dominant form of political geography in theory and in practice. Political relations are defined by the modern nation-state system. Thus national boundaries organize political life, but economic life spans those boundaries. Political organization, authority, and geography do not overlap with the economic geography of globalization. This tension between sovereignty and interdependence will return again and again in our study of modern international affairs. As billionaire currency trader George Soros noted, "We can have a market economy, but we cannot have a market society."

Creating such connections across national boundaries brings good and bad consequences. Globalization can improve the well-being of many, but it also creates new risks and

Closed-economy models approach the examination of economic conditions in a society by ignoring economic factors and conditions external to the nation and considering the nation as an isolated entity. **Open-economy models** are political economy models in which connections across national economies are considered to be important factors in a nation's economic and social welfare and the politics that surround it.

problems for societies. Globalization and global capitalism can blur the economic boundaries of the nation-state, spill over into noneconomic areas of social activity, and challenge the policy autonomy of national governments. In this shifting arena, significant challenges, perils, and opportunities confront governments, societies, firms, policy makers, and individuals. Many praise globalization, while others rail against it. Yet others see both its good and bad consequences and argue for managing the negatives while promoting the positives. This divisive effect goes beyond academic debate to visceral public arguments that evoke conflicting passions and fears. Demonstrators at the meetings of the World Trade Organization and the International Monetary Fund, at the World Economic Forum in Davos, Switzerland, and at other international economic conferences have regularly protested globalization and the transformations in global capitalism.

Many worry about the potential for increasing income inequality and wealth concentration that accompanies market exchange if it is not mitigated by government policies that redistribute opportunities, resources, and wealth—even if individuals are better-off than they were the year before, and the year before that. But concern about globalization extends beyond economic consequences. Many fear its homogenizing effect on the distinct identities and cultures of different societies, as Nike, McDonalds, Starbucks, Coca-Cola, and other symbols of global capitalism insinuate themselves into national economies and consciousnesses. Immigration, another process of globalization, can bring new labor and vitality to some societies, but it can also challenge notions of national identity. Organizations and groups can advocate for fellow citizens to support national producers or resist inflows of foreign goods, people, and ideas, but such choices rest largely in the hands of individuals in market and democratic societies. Perhaps worried about the fate of the classic French bistro in the face of competitive pressures from McDonalds and other fast-food chains, Jack Lang, a former French minister of culture, warned:

The disappearance of languages and cultural forms is the great risk today. Diversity threatens to be replaced by an international mass culture without roots, soul, color, or taste.¹

These debates, protestations, and concerns will continue, both because globalization and international political economic relations are complex and incompletely understood phenomena and because the dominant form of political organization does not mesh with the dominant form of economic organization in the global political economy.

Autarky is a policy that seeks self-sufficiency and isolation from the global economy.

Despite such worries about globalization and its consequences, societies and governments rarely seek complete isolation from the global economy—a status called **autarky**, or self-sufficiency. Autarky

¹Quoted in Walter LaFeber, *Michael Jordan and the New Global Capitalism* (New York: W. W. Norton, 1999).

and isolationism are sure paths to retarding the future growth and welfare of a society. Political economies that have tried to insulate themselves, or have been isolated by external sanction, from global exchange have lagged behind. This is the story of Cold War containment, Iran, Iraq, Venezuela, and North Korea. To be sure, risks to some individuals, families, and communities do accompany the significant societal payoffs to be expected from interacting with the global political economy, and we should not be naively optimistic about the resulting dislocations. Many of these effects will be relatively short-term, but they will nevertheless be costly to those who suffer them. This is true of any major social transformation, regardless of how beneficial the change may be for society in the long term. Change is inherently costly to anyone who prefers the status quo, who fears the uncertainty of the future, or who is under-equipped in terms of the skills needed to adapt to change. Here we see the roots of the conflicted politics of globalization: many stand to benefit from the transformations it will bring, but some legitimately fear the potential costs to them, their families, and their communities.

At the societal level, the potential gains from the global exchange of goods, services, capital, and ideas far outweigh the benefits of self-sufficiency and isolationism, even if such strategies were plausible. Hiding our national heads in the global sand or retreating behind xenophobic national barriers based on fear of foreigners cannot be advanced as a plausible policy for dealing with the world unless we want to consign our economies, politics, and societies to second-class status. Policy makers are confronted with the challenge of reaping the rewards of globalization for the majority in their societies while managing the dislocation of the few. On the international front, they may resort to either unilateral or multilateral strategies to manage the effects of globalization on their societies—either adopting policies without the cooperation and coordination of other governments or attempting to coordinate policies with those of other governments. On the domestic front, policy makers must decide how to manage the inevitable dislocations (hopefully short-term) to the minority who will be negatively affected, for this minority could deny or dampen the benefits of globalization to the majority if they are effective at political action.

THE PAST AS PROLOGUE

Despite recent fascination with globalization and the belief by many that it is a new phenomenon, the transformations in global political economic relations of the later decades of the twentieth century are not unique in the history of human affairs. Significant cross-border market exchange has existed for many centuries. The Dutch became the first commercial and financial global hegemon in the 1600s. They propelled the expansion of global trade and market exchange. Amsterdam became an international financial center. The English and London would replace the Dutch and Amsterdam as the center of global commerce and finance by the 1700–1800s. Global capitalism emerged as the dominant form of international



Pedestrians walk past the skyline of Shanghai's financial district. Since Chinese authorities began liberalizing their economy more than thirty years ago, China has been the fastest-growing economy in the world, averaging more than 10 percent growth per year over the period. This economic transformation stems from China's engagement with the global capitalist economy and has resulted in hundreds of millions of Chinese being lifted out of poverty. China has become the world's largest exporter and second-largest importer, attracts capital investment, and sends millions of students abroad to study and gain skills to benefit the Chinese economy further.

exchange by the late 1700s—early 1800s. Nevertheless, this transition has been halting, plagued with breakdowns, interludes, and reversals along the way. Part III of this book explores the advance and retreat of globalization over the past several hundred years, providing a historical backdrop of important shifts and processes in world affairs.

WHAT IS POLITICAL ECONOMY?

The primary task of this book is to help students of world affairs develop a political economy approach to examining international relations and international political economy. First, what is political economy? The term encompasses a variety of

approaches. For some, description of macro political economic activities constitutes political economy. Macro political economy investigates associations between political activities and substantive performance of an economy. Macroeconomic numbers such as gross national product (GNP), gross domestic product (GDP), national debt and deficit, inflation, unemployment, exchange rates, size of the public sector, balance of trade, central bank interest rates, investment, money supply, and productivity describe the state of the national political economy, all supplying information about a nation's aggregate welfare. We use such descriptive characteristics to infer how well or poorly governments are performing in managing their economies, and what areas governments and societies need to target for improvement. From a macro political economic perspective, these descriptions can serve as dependent variables that are influenced by government policy choices, or they can be considered as independent variables that motivate and influence a government's choice of policies. In either case, the substantive questions revolve around the nexus of government and economic behavior: How do government actions affect the state of the economy, or how does the state of the economy affect government actions? Many approaches to international political economy focus on such macro depictions. These depictions are important at both the domestic and international levels, and they can be a component of our discussion of political economy, but they differ from the micro approach emphasized throughout this book.

The micro political economy approach focuses on the processes that influence, motivate, and constrain the choices of individual political actors. We will emphasize the rationality, preferences, capabilities, calculations, strategies, and choices of individual political economic actors in social settings where their choices interact with the choices of others to produce the social outcomes we observe. In this approach, political economy describes the processes of choice that lead to government policies and to social, economic, and political outcomes. This approach seeks to investigate and construct the *micro* foundations of *macro* outcomes. Individual choices aggregate to produce macro outcomes, but we need to understand why individuals make the choices they make if we are to understand and thus be able to influence broader social outcomes in the world. We can then use these microfoundations to explain why decision makers make the choices they do, how context affects their individual calculations, and how individual choices aggregate to produce the social outcomes that we observe.

These processes are just as relevant to understanding decisions about war and conflict as they are to understanding why governments implement some economic policies and not others. Conceptualizing political economy in this way, we attempt to discover the inner workings, or causal foundations, of actions in political arenas. We focus on the calculations and choices of individuals in social settings, the incentives that influence these calculations and choices, and the processes by which individuals interact, compete, bargain, compromise, and even fight over policies, elections, regulations, and rules. The choices of numerous actors in the political sphere interact and aggregate to produce the social, economic, and political outcomes that are reflected in the macro political economy. They affect the allocation of gains and losses in society, creating winners and losers. From our micro perspective, political economy is a story about the processes and means by which members of society decide on policies and rules of the game that allocate gains, losses, and risks.

So why is this micro approach to politics considered political economy, and not political anthropology, political sociology, political psychology, or some other strategy of analysis? Simply, we assume that political actors use a specific form of logic—an economic logic—when evaluating alternatives as they engage in the processes of political bargaining and behavior. This approach to decision making compares the costs and benefits of alternative strategies and the likelihood of different outcomes given the possible actions of others. In this text, we apply this political economy approach to understanding world affairs, but it can be used to gain insight to social phenomena that are not exclusively international, such as migration, voting decisions and rules, judicial activity, political and civil liberties, ethnic conflict, discrimination, gender rights, fiscal policies, health care, and other political activities.

THREE CORE ASSUMPTIONS WITHIN THE MICRO POLITICAL ECONOMY APPROACH

Three powerful assumptions underpin the tools of explanation developed in this book. First, *we live in a world of scarce resources*. Second, *political actors seek to survive*. Third,

Scarcity is the concept that all items and resources that we consume—those produced by human beings and those produced by nature—exist in some finite amount, regardless of the demand for those items; this is a key assumption because it generates the conditions for competition, cooperation, and conflict over the distribution of resources and opportunities. **Costs** are the goods that we forgo when we choose to consume particular items.

decision makers act as if they are rational. Let's consider each of these more carefully, for the logic of our micro political economy approach builds on these assumptions. Making these assumptions, and others, explicit also creates better opportunities to challenge them. Unstated assumptions prove more difficult to challenge because they offer greater wiggle room, whereas more explicit approaches encourage rigorous testing and build a healthy skepticism into the process of investigation.

Scarcity

Scarcity is a key assumption, as it generates the conditions for competition, cooperation, and conflict over the distribution of resources and opportunities. It creates the possibility for relative winners and losers to emerge. In a world of plenty—a world absent scarcity—men and women could consume whatever they want, whenever they want, without impinging on the choices of others. No competition or conflict over the distribution of resources would exist, nor would there be a need for compromise or cooperation to overcome barriers to the distribution or allocation of resources. Selfish actors—gluttons—could consume as much as they wanted without diminishing the supply of resources for others. Hunger, impoverishment, jealousy, and want would not exist or make sense. In such a world, envy and *egoistic* (selfish) actions would be meaningless, as they would create no costs for others and would not affect an individual's own opportunities or those available to others. Neither money nor any other medium of exchange would have value, for all could consume what they wanted without concern for the rules of supply and demand. **Costs**, those things that we forgo when we choose to consume particular items, would become meaningless, as no costs would exist. We would not have to forgo consumption of some items because we elected to consume other items. A world without scarcity would translate into an absence of constraints on consumption, as well as an absence of the conditions that spawn distributional conflict, competition, and cooperation. A world without scarcity would be literally a Garden of Eden.

Unfortunately, we do not live in such a garden of unlimited resources. All items we consume—those produced by humans and those produced by nature—exist in some finite amount, regardless of the demand for those items. In a world of scarce resources, items in high demand and low supply become expensive and valuable relative to items in high supply and low demand. Scarcity may appear as a budgetary constraint, such as how much money is in one's wallet; as a resource constraint, such as height and strength; or as an information constraint, such as incomplete information or limited ability to process information. In a world of scarcity, mechanisms of exchange become important. Scarcity creates the conditions for politics, which is a use of coercive means to determine the rules of social,

political, and economic exchange, to allocate resources, to divide the proverbial pie, and to decide who gets what, why, and how. Politics imposes a nonvoluntary component upon exchange and allocation. For example, if you vote for the Democrat but the Republican wins, you still must consume the political policies enacted by the Republican.

Politics helps create rules for social, economic, and political exchange and allocation within and across communities. Such rules, if violated, can trigger penalties and punishment. We call such rules **institutions**, a concept that we examine more carefully in chapter 8. These institutions or rules may be formal or informal.

Examples of formal institutions include constitutions, electoral rules, statutory laws, and regulations. Examples of informal institutions are habits, norms, and loosely defined social practices. Formal institutions enjoy formal sanctioning mechanisms such as governments to enforce rules and apply penalties for lack of compliance, whereas informal institutions lack such explicit enforcement mechanisms. Informal institutions can arise from a variety of sources, such as common beliefs and practices, differences in power, the emergence of societal norms, religious prescriptions, folklore, and voluntary cooperation. Informal rules are nonstatutory, but they may prove just as forceful as formal rules in motivating and constraining human activity. The use of threats, penalties, and punishment is by definition coercive, as these measures constrain human choice (that is, without such constraints a person would choose differently), but they may be necessary to encourage social, economic, and political exchange that can be socially beneficial within and across national boundaries. The rules of exchange and allocation produced in political arenas create relative winners and losers in political economies. Constructing a law, rule, or regulation, or invoking a social practice one way versus another, affects the distribution of resources and influ-

Institutions are the formal and informal “rules of the game,” laws, and practices that structure the incentives of individuals.



Antiglobalization protesters regularly voice their opinions at Group of 8 and Group of 20 (G-8 and G-20) summits of world leaders. Here, in reaction to the G-8 meeting in Paris during May 2011, activists from the humanitarian nongovernmental organization Oxfam pose as (from left) Russian president Dmitry Medvedev, British prime minister David Cameron, U.S. president Barack Obama, French president Nicolas Sarkozy, Italian prime minister Silvio Berlusconi, German chancellor Angela Merkel, Japanese prime minister Naoto Kan, and Canadian prime minister Stephen Harper playing poker, with the stakes being the health of the world economy. Such demonstrations reflect the intensity of opposition among critics of globalization and the pressures that policy makers must confront and manage in formulating policies and laws related to the processes of globalization.

ence in societies. Altering such institutions moves the boundaries of distribution and allocation; therefore, laws and regulations themselves can become targets of fierce competition, sometimes leading to cooperation and compromise, sometimes to conflict.

Political Survival

The second assumption on which the tools in this book build is that political actors and governments want to survive—to stay in office and in power—and will act to survive. In democratic electoral systems, these actors work to enhance their prospects for reelection. In less democratic systems, political actors may instead work to build constituencies among those groups that can protect them, such as the military or select segments of society. We call the group essential to a political actor's survival the *selectorate*. The assumption that survival is an important goal helps us to analyze the choices made by policy makers, by asking how political actors view such choices as affecting their prospects for political survival.

This assumption does not imply that politicians have no preferences about the state of the world or about the public policies that affect the state of the world, but it does suggest that they evaluate policies for achieving those preferences within a context that involves assessing how their choices will affect their ability to survive politically and whom they must satisfy to survive. A politician who finds her policy preferences in conflict with her ability to survive faces difficult choices and trade-offs. Such conflict is very common, and it underpins much of the cynicism about politics that is generated when politicians seem to compromise their policy preferences in order to stay in office. However, if selecting policies independent of considerations about reelection and political survival should lead to her political demise, the politician would not be able to promote her policy preferences in the future, whereas her opponent, who has different policy preferences, would. Compromising on policy preferences to improve the odds of political survival is thus akin to retreating in order to fight another day.

Rationality

Our third assumption is that people behave as if they are rational. This is not to claim that people really are rational beings, but rather that they behave and make choices *as if* they are. Explicitly assuming that people behave as if they are rational, regardless of whether they really are, embeds decision making within a particular logic that can be applied to politicians, policy makers, and interested parties. This logic is key to systematic and consistent investigation of the actions of such actors within political economies, for it provides a powerful and explicit lever for analyzing behavior and understanding decision making.

What do we mean by *rationality*, and why is it such a useful tool? Rationality describes a particular process of choice. This focus on the choices of individuals is called

methodological individualism. It amounts to a claim that individuals—not larger units of aggregation such as nations or societies—make choices. A variety of approaches exist to investigate the choices of individuals: cultural anthropologists place their primary focus on the effects of culture on individual choice; sociologists emphasize the influence of group dynamics on individual choice; and psychologists look at psychological, emotional, biological, and subliminal constraints on individual choice. The assumption of rationality in this book on political economy focuses our attention on a particular means by which individuals choose among alternatives under constraints of scarcity.

Methodological individualism is a focus on the actions and choices of individuals—not larger units of aggregation such as nations or societies.

RATIONALITY, PREFERENCES, AND SELF-INTEREST EXPLORED

Because the assumption of rationality is central to the micro political economy approach of this text, we need to take a closer look at some mechanics of this assumption and how it interacts with the first two assumptions about scarcity and political survival. Assuming that political economic actors behave as if they are rational means that we assume they can systematically order their preferences over the state of the world, along with the expected outcomes of their choices, and that the ordering will be consistent over time and in their self-interest. There are many ways that preferences could conceivably be ordered: randomly, as in drawing them blindly from a hat; alphabetically; or by some other arbitrary scheme. The rationality assumption holds that preferences are ordered in terms of self-interest.

Ordering Preferences

To understand the ordering principle that underpins rationality and our approach to individual choice, we first must ask, what are preferences and self-interest? At the level of the individual, **preferences** are simply statements about individual wants such as food, wealth, entertainment, security, community, justice, status, respect, influence, fairness, and liberty. These preferences include material wants as well as social and spiritual wants; a want can be a preference over the state of the world, as the state of the world is instrumental in affecting the distribution of other wants. **Self-interest** is simply a statement about how an individual's preferences affect her interpretation of her position in the world. Economists call this *utility*, which is shorthand for everything that affects an individual's expected satisfaction. Will a particular choice increase or decrease an individual's utility? Self-interest assumes that individuals will select choices by seeking to

Preferences are statements about individual wants, including material wants as well as social and spiritual wants. **Self-interest** is the notion that people make choices based on their hierarchies of preferences and their budgetary constraints.

improve their utility, or expected satisfaction. Utility sometimes refers to goodies such as economic wealth or income, which are relatively easy to measure. But utility can also include noneconomic goodies such as health, social status, happiness, family, or some other aspect of life that an individual values, which can be relatively difficult to measure. Remember, we have assumed that decision makers, or political actors, will seek to survive and to advance their interests. So one criterion for evaluating and comparing preferences is determining how they affect the survival and status of the decision maker.

This approach to investigating decision making involves the following assumptions:

- People act as if they can discriminate among their preferences.
- People act as if they can order their preferences in terms of most to least desirable.
- People can evaluate and rank possible outcomes of their choices in terms of their preferences because they recognize that there may be some discontinuity between a choice based on a preference and the actual outcome.
- People will choose to obtain an expected outcome that is higher in their ranking rather than a lower one given their budgetary, resource, or information constraints.
- People will be fairly consistent in their choices and preferences over time and, if presented with the same list of preferences and outcomes at different times, will rank them similarly.

Assuming that people behave *as if* rational and that they can place their preferences along a single dimension based on their self-interest—thus creating a hierarchy of preferences from most to least preferred—is a vast simplification and potentially a tenuous one, but it is nonetheless useful as the first step in adopting rationality as an analytic tool. It supplies a systematic way of discriminating across preferences and alternative outcomes and of evaluating different courses of action. We can employ this assumption of rationality to understand why a decision maker might choose one action over another. It enables investigators to examine alternative courses of action or strategies for achieving the actor's objectives and to evaluate those strategies in terms of their potential to produce the preferred objectives and of their likely costs. This tool allows investigators and individuals to evaluate the trade-offs between costs and benefits, to weigh disadvantages and advantages.

Rationality under Scarcity and Political Survival

Our three core assumptions work together to shape our inquiry. Understanding the assumption of rationality returns us to the scarcity and political survival assumptions. In a world of plenty, we would not have to consider the criteria that guide individual choices, because decisions would not matter in terms of consumption opportunities. Irrelevant to the distribution of resources, political survival would also be meaningless. But scarcity places costs on decision making because making choices involves forgoing other possibilities, affects distributional outcomes in society, and makes political survival relevant. The assumption of

scarcity creates both a need for decision criteria to make trade-offs and a demand upon politicians to act in their self-interest in terms of political survival. Rationality is one such decision criterion, and it is constrained by scarcity. Decision makers' time, energy, and capabilities are scarce resources. They may need to make choices with incomplete information, limited by the demands of time and handicapped by the dilemmas of trying to forecast an uncertain future. Such constraints can affect a decision maker's process of choice and force her to allocate more time and effort to some decisions than to others. Together, these assumptions help us to investigate why a political actor may focus on one objective over another, by making it clear that a decision maker does not value all objectives equally but discriminates across a wide range of objectives as she allocates her limited time and energy.

Rationality prescribes the more efficient choice, determining which strategy can be expected to deliver the largest payoff, given a preference ordering and given the cost constraints. When the expected costs of obtaining the most preferred objective are too high, the assumption of rationality allows us to evaluate the trade-offs between secondary objectives, strategies to obtain those objectives, and the cost of each strategy. The assumption of rationality means that we expect decision makers to choose the course of action that is most likely to produce the best outcome for them given costs and benefits across the alternatives. For example, despite a general trend toward trade liberalization—which is consistent with their own dominant preference for free trade over government intervention in trade—policy makers in the United States occasionally create and maintain barriers to trade. Such barriers have been imposed on products such as textiles, shoes, steel, and automobiles. At first glance, this practice appears nonrational, because it seems to conflict with the preference ordering of policy makers. But policy makers also want to survive, and we can assume that this preference generally dominates other preferences. If supporting free trade in a particular sector, such as textiles or shoes, would severely threaten a politician's ability to survive because it would produce dislocated and unhappy voters, we should expect that politician to support a less costly policy. If enough politicians were threatened in this way, we would find an explanation based on rationality for the adoption of trade barriers in particular sectors.

Putting our three core assumptions together suggests that as policy makers operate in a world of scarcity, they will act to further their policy preferences within the limits of their ability to survive, and they will follow a logic based on rationality to do so. This means that they will act in their self-interest—broadly defined as a calculation of how their choices will affect their ability to survive and prosper, given the alternatives. Ideally, their self-interest will be compatible with societal welfare, but there are no guarantees that the interests of policy makers and those of the broader society will overlap significantly.

Two Properties of Preference Ordering: Completeness and Transitivity

Next we consider two important properties that are involved in using preferences and rationality to examine behavior: completeness and transitivity. **Completeness** establishes

that two alternatives are comparable and can be placed in a hierarchy. If we can say that an individual prefers one alternative to another (or vice versa) or is indifferent between the two, we are establishing qualities about the alternatives that constitute completeness. **Indifference** means, quite literally, that an individual is indifferent between alternatives, that they are

Completeness is the quality that defines two alternatives as both comparable and capable of being placed in a hierarchy. **Indifference** is the state of impartiality, or lack of preference, between alternatives that are equal but still comparable. **Transitivity** is the quality that defines three or more alternatives as comparable and capable of being placed in a hierarchy of preferences. A **hierarchy of preferences** is the ranking of preferences along a single dimension based on self-interest—creating a hierarchy from most to least preferred.

equal but still comparable. Completeness is a useful concept because it allows us to study an individual and say that she prefers one alternative to another or is indifferent, and then to expect her to behave according to that preference ordering.

Transitivity extends the logic of comparability that is reflected in completeness to more than two alternatives. Transitivity means that three or more alternatives are comparable and can be placed in a hierarchy of preferences. For example, imagine that an individual has to choose among three alternatives for dinner: steak, chicken, and fish. She begins by first looking for completeness, or comparability between two alternatives, by comparing each pair of

alternatives: steak and chicken, chicken and fish, and steak and fish. Her preferences are transitive if she prefers steak to chicken, chicken to fish, and steak to fish, because this pattern permits a strict ordering or **hierarchy of preferences**. If we were trying to understand her preferences so that we could take her to dinner for her birthday, determining that she has a strict hierarchy of preferences would make our task easier. Even if she were indifferent between several alternatives, her preferences would still be transitive if they could be arranged in order and we could therefore anticipate what restaurants would give her the greatest satisfaction for her birthday celebration.

Unfortunately, not all choice situations are this simple. In relatively rare cases, individuals display complete but intransitive preferences. For example, our birthday celebrant may prefer steak to chicken, chicken to fish, but fish to steak. Every alternative is comparable, which satisfies completeness, but we cannot build a strict hierarchy across the three alternatives. This leaves us with the dilemma of where to take her for her birthday dinner if we want to provide her with the greatest expected satisfaction. We might say that individuals who can fulfill a condition of completeness but not transitivity are nonrational or confused, or perhaps that life is complicated and rational people can have preferences that fall along more than a single dimension. Both life and the investigation of choices are much simpler when we can establish a preference ordering that falls along a single dimension, as in figure 1.1; then we can simply anticipate choices being made for more preferred over less preferred alternatives, given the constraints of resource scarcity. But if we add another dimension to the choice of food—such as the ambience of the restaurant, whether it is quiet or loud, as in figure 1.2—both the investigation of individual choice and the

choices themselves become far more complicated. This added complexity creates uncertainty about individual choice and interjects considerations of costs or trade-offs into the selection of one alternative over another. Figures 1.1 and 1.2 offer useful visual tools for examining the distribution of preferences over outcomes. Each is a spatial depiction, or what is called a **spatial model** of an individual's preferences.

A **spatial model** is a useful visual tool for examining the distribution of preferences or policy in geographic or geometric space. An **intransitive collective outcome** is a social preference ordering constructed through the aggregation of the preferences of individual group members and in which the group outcome does not represent a strict hierarchy of social preferences.

In reality, this problem is relatively rare for individuals. When forced to select between alternatives, individuals can usually produce a complete and transitive preference ordering—they are able to force their individual preferences into a strict hierarchy. But the dilemma of intransitive preferences is quite likely to arise in the construction of the preference orderings of collectivities such as groups, societies, or electorates by means of some democratic voting rule or market exchange mechanism. The aggregation of individual preferences by such means can often produce an **intransitive collective outcome**, even if all the individuals voting have expressed complete and transitive preferences. This possibility opens the door to troubling questions about whether democratic and market processes of choice in economic and political exchange can actually maximize the social welfare function of society—whether individuals voting in accordance with their complete and transitive preference orderings can indeed produce a complete and transitive collective preference ordering that optimizes the social welfare of society. If individuals and groups confronted with three or more alternatives satisfy the condition of completeness but not that of transitivity, this element of uncertainty presents potential hindrances to our use of rationality as an analytical tool. (The appendix to this chapter offers examples of individual and collective preferences in the political arena that are complete but intransitive.)

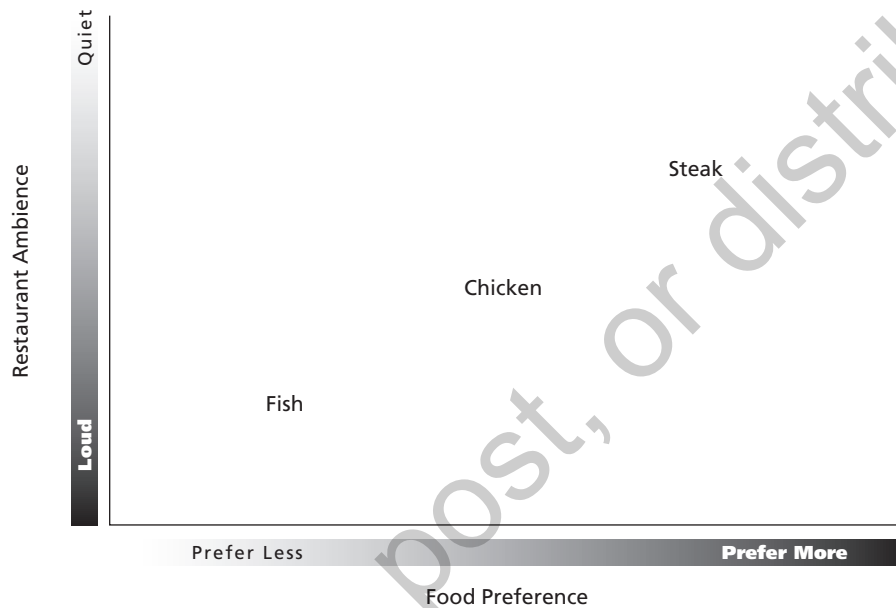
This conceptualization of preference ordering describes a particular logic that assumes rationality and a specific process by which individuals select among alternatives. Even if individuals have intransitive preferences, we can use this logic as a tool to investigate choices in politics, economics, and other avenues of life. This logic allows us to evaluate

FIGURE 1.1

Complete and Transitive Preference Ordering along One Dimension



FIGURE 1.2 Preference Orderings along Two Distinct Dimensions



the preference orderings of individuals over the range of alternatives they consider and to consider the trade-offs and costs across such alternatives. This process amounts to a cost-benefit analysis of possible alternative choices, in which we consider the preference ordering of outcomes, whether these outcomes satisfy conditions of completeness and transitivity, the likelihood of obtaining each alternative outcome given our available strategies and resources, and the cost of obtaining each alternative outcome. This type of analysis offers a strategy for understanding past choices and anticipating future choices. We can anticipate that decision makers will select courses of action that are most likely to produce the best outcomes on their hierarchies of preferences, given cost constraints. This logic provides the foundation for a systematic strategy to examine why decision makers make the choices they do.

CONTEXT AND THE INTERDEPENDENCE OF CHOICES: OPPORTUNITY FOR STRATEGIC BEHAVIOR

We must be careful in building upon the assumption of rationality. Even after ordering preferences and determining whether they have properties of completeness and transitivity that fall along a single dimension to produce a consistent ordering, choice may not be

straightforward. We should consider two important reasons why: *choice is not independent of context*; and *choice is not independent of the actions of others*.

Choices occur within contexts. Taken independent of context, rationality becomes a trivial—or worse, pathological—assumption. Context influences costs and the likelihood of obtaining particular outcomes. The same rational decision maker may select one strategy in one context and another strategy in another context. This does not mean that the decision maker behaves nonrationally, but that a change in context can affect her evaluation of the trade-offs, costs, and gains involved with different strategies. The policy maker who decides to lower trade barriers during a period of economic expansion may resist such a policy change during a period of economic contraction. The policy maker who advocates military intervention in Somalia, Iraq, or Serbia for humanitarian reasons may resist such intervention in Rwanda or North Korea. Politicians who advocate placing limits on whaling in order to protect a species from risk of extinction may not be inclined to impose limits to protect fishing stocks facing similar consequences. A shift in context produces this change, not a shift in rationality. Rational action is embedded in context. Therefore it is important to study decisions within their contexts, which inform us about the options and constraints that decision makers encounter.

The second reason for apparent inconsistency is that choice is not independent of the actions of others. This complication is a function of the structure of context, of who the other parties are within a context, the preferences of those different parties concerning outcomes, their individual choices, and the mechanisms that aggregate those individual choices to produce a social or collective outcome. Interesting outcomes in social settings are generally consequences of the interactions of multiple individuals' choices and actions. Most interesting social outcomes, those depending on the actions of more than a single person, are produced by the interactions of multiple individuals and their strategies. This interdependence raises the opportunity for strategic behavior, in which individuals are aware that an outcome depends on the interaction of their choices with others' choices, so they try to select strategies that anticipate what others may do or manipulate the context to affect others' choices. If my most preferred outcome depends on my choice of strategy and a specific choice of strategy by another person, but that person would never make that specific choice, then my selecting a strategy to obtain that preferred outcome is fruitless. It might even prove perverse, if the interaction of such choices should produce a far worse outcome than if I had compensated for the other person's likely choice by making another choice accordingly.

GAME THEORY: MODELING CONTEXT AND INTERDEPENDENT CHOICES

“You mean, the theory of games like chess.” “No, no,” he said. “Chess is not a game. Chess is a well-defined form of computation. You may not be able to work out all the answers, but in theory there must be a solution, a right procedure in any position. Now real games

are not like that at all. Real life is not like that. Real life consists of bluffing, of little tactics of deception, of asking yourself what is the other man going to think I mean to do.”

—John von Neumann, in William Poundstone, *Prisoner's Dilemma* (1992)

Game theory is the systematic study of rational choice in strategic settings.

Game theory, the systematic study of rational choice in strategic settings, is a useful tool for modeling and investigating social behavior that involves rational calculation and interdependent choices.

Strategic settings are those situations in which outcomes depend on the interactions of the choices of two or more individuals. Decision makers must consider the strategies of others in this decision context, their likely choices, and how those choices interact to produce individual and collective outcomes. Figure 1.3 uses several simple games to illustrate how individual choices interact to produce an outcome, and how the same rational individuals may behave differently if the context varies. The games in figure 1.3 are models of decision settings or contexts in which two decision makers must decide among alternative strategies. By definition these models are simplifications, but they capture some important underlying dynamics of a choice situation.

In these games, each decision maker, or player, has a choice of two strategies, *A* or *B*. The payoffs the decision makers will obtain if their choices intersect are located in the cells of figure 1.3. In each cell, the payoff for Player 1 is shown before the comma and that for Player 2

FIGURE 1.3

Strategy and Choice in Different Contexts

GAME A

Player 1's Choice	Player 2's Choice	
	Strategy A	Strategy B
Strategy A	20, 10	5, -1
Strategy B	-1, 5	0, 0

GAME B

Player 1's Choice	Player 2's Choice	
	Strategy A	Strategy B
Strategy A	20, 10	5, 15
Strategy B	10, 20	-5, -5

appears after the comma. For example, in Game A, if Player 1 and Player 2 both select Strategy A, Player 1 will receive 20 and Player 2 will receive 10. If we assume that the decision makers will act as if they are rational, we can rank all the outcomes or payoffs in terms of the players' preferences (more is better in this example): given the possible outcomes in Game A, Player 1 prefers 20 to 5 to 0 to -1 ($20 > 5 > 0 > -1$) and Player 2 prefers 10 to 5 to 0 to -1 ($10 > 5 > 0 > -1$). These preference orderings are complete and transitive. Now, each player must consider the other player's expected behavior given her preferences and choice of strategies, and then select the strategy that can be expected to produce the greatest benefit contingent upon the other player's choice of strategy.

This is a nice game, as both players can obtain their best outcomes by selecting Strategy A. Player 1 knows that Player 2 prefers the outcome produced by Strategy A, and Player 2 knows that Player 1 prefers the outcome produced by Strategy A. There is no tension or conflict in this game because both players can select their preferred strategies and obtain their preferred outcomes. Each has a **dominant strategy**, which is the one she would select regardless of what the other player does. In this case, the dominant strategy produces the best collective outcome, 20 10, and everyone is happy! This is the situation that eighteenth-century economist and philosopher Adam Smith envisioned in *The Wealth of Nations* with his argument about the functioning of the **invisible hand** in efficient markets. In such settings, individuals only need to act sincerely, choosing their most preferred outcomes to obtain the best possible collective outcome.

In Game A, a dominant strategy exists for both players, whereby the intersection of their choices—their payoffs—is stable, and neither player can improve her payoff by unilaterally selecting another strategy. This is called a **stable equilibrium**, or, in game theory terms, a **Nash equilibrium**, named after its inventor, John Nash (who was the subject of the book and award-winning film *A Beautiful Mind*). This idea transformed microeconomics, and Nash won the Nobel Prize in Economics for its invention. Equilibrium is nothing more than a situation in which activity has stopped; there is no switching of strategies. Aside from this quality of stability and its value for predicting and explaining behavior, there is nothing inherently special or attractive about equilibrium, which may be normatively good or normatively bad.

An international agreement about fishing rights that allocates catch shares and ensures survival of a fishing stock would be a normatively good equilibrium from the perspective of those who think species preservation is a good outcome. Being locked in ethnic conflict or a civil war might also be equilibrium, if neither side could improve its prospects for survival

Dominant strategy is a strategy that a player would select regardless of the actions of other players. The **invisible hand** is an idea proposed by Adam Smith, who theorized that an unseen force guides self-interested individual behavior in competitive markets to promote the welfare of society without deliberate intent.

A **stable equilibrium** is a situation in which no actor can improve her situation by unilaterally making another choice. This demonstrates the importance of the interaction of choices in social settings. This is also called a Nash equilibrium.

by unilaterally selecting another strategy. But we would likely consider this situation as normatively perverse, for the equilibrium promotes continued killing and destruction.

Game B changes the context or structure of the interaction between the same decision makers. In terms of payoffs, Player 1 prefers 20 to 10 to 5 to -5 ($20 > 10 > 5 > -5$), while Player 2 prefers 20 to 15 to 10 to -5 ($20 > 15 > 10 > -5$). Again, these preference orderings are complete and transitive. In this situation, Player 1 has a dominant strategy, Strategy A, which she will select regardless of Player 2's choices. Player 1 prefers 20 to 10 and 5 to -5 , which are the different outcomes she can expect between Strategies A and B, dependent upon Player 2's choice of strategy. So Player 1 will always select Strategy A in this game. If Player 2 recognizes that Player 1 has a dominant strategy of A, she can make her decision contingent on that knowledge. If she wanted to maximize her payoff without any knowledge of Player 1's strategy, she would choose Strategy A, with the expectation of obtaining 20 should Player 1 choose Strategy B. But, as Player 2's payoff results from the intersection of her choice with Player 1's choice, she would receive only 10 instead of the expected 20, because Player 1 will have selected Strategy A. What a disappointment! There is no way Player 2 can obtain 20 because Player 1 has no incentive to shift strategy. But if she recognizes that Player 1 will always choose Strategy

A **social trap** is a situation in which what appears to be an individual's maximizing, self-interested choice for obtaining a preferred outcome results in a subpar outcome both for the individual and for the larger group or society; this unexpected outcome occurs because of the structure of interactions of the choices made by multiple individuals.

A, Player 2 can do better for herself by choosing Strategy B and obtaining a payoff of 15, which is much better than 10. By acting strategically—selecting a strategy that does not reflect her most preferred outcome in an absolute sense but represents her best choice given the structure of her interaction with Player 1—she will do better.

In both games, we had rational decision makers, but their choices changed with the shift in context.

Context is not trivial; in fact, it is critical to understanding choices, as social settings can influence payoffs by determining how choices interact. We return to game theory models later to illustrate how contexts can produce social traps in economic and political markets. A **social trap** is a situation in which what appears to be an individual's maximizing, self-interested choice to obtain a preferred outcome actually results in a subpar outcome both for the individual and for the larger group or society. This unexpected outcome occurs because of the structure of interactions of the choices made by multiple individuals.

OUTCOMES VERSUS CHOICE: USING THE RATIONALITY ASSUMPTION

The preceding section and the appendix at the end of this chapter highlight an important distinction between choices and outcomes. One might reasonably ask why, if policy makers behave as if they are rational, their choices sometimes produce costly and seemingly perverse

outcomes. Should we not expect rational decision makers to be reasonably successful in attaining their preferences, and only occasionally to fail in their efforts? And if their choices fail to attain their preferred outcomes, shouldn't they be able to avoid extremely costly and perverse outcomes? When we observe bad outcomes—such as the destructiveness of total war, the failure of a trade policy, an international financial crisis, or the extinction of a fish species due to overfishing in international waters—does this mean that policy makers intended to produce such outcomes through the careful and rational comparison of alternatives and strategies?

Did the leaders of European nations in 1914 rationally intend to reduce the population of Europe by approximately ten million people when they entered into World War I? Did Hitler rationally seek the outcome of fifty-five million dead, thirty-five million wounded, some three million more lost and unaccounted for, his own death, and the complete destruction of his Germany when he took the steps that would embroil much of the globe in World War II? When Congress enacted the Smoot-Hawley Act in 1930, dramatically raising tariffs on U.S. imports and provoking other nations to raise their tariff rates, did Smoot, Hawley, and the other legislators who voted in favor really want to torpedo the global economy? Did President Herbert Hoover, as a rational decision maker, known for his humanitarian efforts in Europe after World War I, consciously elect to promote economic disarray and human suffering when he decided to sign the Smoot-Hawley Act against the advice of more than one thousand economists? The answer to all these questions is, unequivocally, No! But, then, how can rationality help us to understand choices that produce such perverse outcomes?

Backward Induction

These examples illustrate a very important lesson for how we use the rationality assumption to investigate human behavior: *the consequences of choice differ from the motivations of choice*. It may seem obvious, but it is important to understand that a decision differs from an outcome. As the simple games in figure 1.3 illustrate, in social settings (those that involve more than one person), outcomes result from the interaction of choices but are not the choices themselves. Otherwise, a person's choice to play a lottery game would be equivalent to winning. The rationality assumption helps us to investigate the individual motivations leading to decisions, but it does not necessarily explain the consequences of those decisions. If we assume that people operate as if they are rational, we can look at a decision situation and work backward to try to understand the rational calculations that could lead to the decision under examination. This process, which is called **backward induction**, is a very powerful tool for probing history and understanding politics.

Backward induction is an analytical tool for trying to understand why people make the choices they make. One starts by examining a decision and asking what would lead a rational decision maker to make such a choice. By working backward, one attempts to understand the rational calculations that could lead to the decision.

Backward induction places the primary focus of analysis on the decision rather than on the outcome of that decision. It involves starting with a decision—not its outcome—and asking what did the decision maker hope to accomplish with her choice, what were her objectives, how did she rank those objectives, and how did she understand the preferences and likely choices of others that could impinge on her actions? How does her choice of a particular strategy allow us to evaluate her understanding of the trade-offs between objectives and the cost of the strategies to obtain those objectives? The assumption of rationality means that we expect a decision maker to choose a course of action most likely to produce the best outcome given costs and benefits. This expectation gives us a tool to help us re-create the scenario of a decision we hope to understand, even if the outcome of that choice appears nonrational. We try to put ourselves in the decision maker's shoes. We look for supporting evidence in the historical record, in archives, in interviews with participants to an event, and in any data that provide a glimpse of the context in which the decision was made. The assumption of rationality provides a logical framework in which to evaluate that information. Under the rationality assumption, we do not expect decision makers to make random choices or to select their second or third preferences if their first choices have equal or lesser costs. Consequently, we seek to understand how a decision maker came to view her choice as the best option given her understanding of the costs and benefits of alternative strategies.

Focusing on an outcome is very different from focusing on motivation when we investigate the choices that have produced an outcome. Outcomes attract our attention because we hope to understand what causes crises and disasters, as well as what promotes good and fruitful outcomes in the global political economy. But to focus on an outcome as we try to understand the choices leading to that outcome represents a potential trap that ensnares many investigators. Outcomes result from the interaction of choices made in a world where decision makers are limited in the time and energy they can devote to any single choice, where they are not fully aware of other decision makers' understandings of the world, and where they are not equipped with functioning crystal balls. An outcome may occur as expected and predicted, it may be unanticipated, it may produce unintentional consequences, or it may be just one of many possible outcomes that could have occurred—but decision makers have weighted all those possible outcomes with a probabilistic evaluation that has proven to be accurate or faulty.

An Example of Backward Induction

Let's return to the Smoot-Hawley Act of 1930 as an example. Smoot-Hawley raised U.S. tariff barriers to heights not seen before or since. In retrospect and with 20/20 hindsight, Smoot-Hawley looks like one of the worst, most destructive policies ever implemented in American politics. Were Smoot and Hawley seeking such infamy when they introduced their legislation and nurtured its passage through Congress? Did they consciously seek to create a disaster in the global economy and fuel a global depression that helped lead to World War II? Were they hoping

that their names would be forever associated with an unmitigated policy disaster? If we were to begin with the outcome of worldwide economic depression and contraction that followed Smoot-Hawley and employ the rationality assumption and backward induction, we would be assuming that policy makers wanted to encourage a worldwide economic catastrophe.

A more appropriate research strategy to understand the passage of Smoot-Hawley, however, would ask under what conditions legislators would view the Smoot-Hawley Act as a rational strategy or a best choice given their understanding of the costs and benefits of different strategies. What did Smoot and Hawley and the supporting members of Congress expect to accomplish when they passed the legislation? Clearly they did not expect what happened, or we would have to call them crazy or sick. More likely, they were civil servants seeking to promote the welfare of their constituents and to enhance their own prospects for reelection. These goals required cushioning their constituents during a time of economic downturn and uncertainty. Jobs, livelihoods, and communities were being threatened, creating a situation that could easily translate into disgruntled voters. In response to this situation, the Smoot-Hawley legislation sought to transfer the costs of the economic downturn—job losses and other dislocations—to workers and producers in other countries by erecting barriers to their access to U.S. markets. Protecting U.S. markets for U.S.-produced products by raising the costs of imported products, Smoot-Hawley was an attempt to shift the costs of economic hardship overseas.

Senator Smoot and Congressman Hawley had good reason to believe in the soundness of their strategy, for it had worked numerous times in the past. Indeed, the U.S. economy grew up as a highly protected economy with high barriers to entry in particular sectors, and the U.S. Congress had raised tariff protections in the agricultural sector as recently as 1922 without destroying the global economy. But the position of the U.S. economy in the global context had changed by 1930, so that their actions instead contributed to a process of impoverishment, which ensured their electoral demise.

An outcome may attract us to a particular problem, but the focus on choice permits us to seek out the motivations and expectations underpinning the choice, to conduct an autopsy in order to learn what went wrong or what went right. Asking what decision makers expected to achieve is the first step toward understanding the microfoundations of the macro outcomes that we observe in the world. This approach offers a useful strategy for analysis of the decision-making process. Often we do not have access to decision makers at the time of their choices—we cannot be flies on the wall, or parties to their mental musings and policy deliberations. Sometimes these political actors are dead, sometimes they are retired, sometimes they have selective and retrospective memories that rearrange history to make them look better, and sometimes they are leaders in other countries about whose motivations we have limited information. Ultimately, we want to have some means of inferring why policy makers did what they did, or what they will do. Retracing the process of rationality, along with our other core assumptions, provides us with tools to help us in our attempts to explicate and anticipate choices.

THE PURPOSE AND PROCESS OF SOCIAL SCIENCE

In this volume we approach the study of world affairs as a scientific activity—a social science—that describes the processes by which we generate, assess, and accumulate knowledge. As we examine and attempt to understand world affairs of the past, present, and future, we need systematic tools and frameworks to assist our efforts. We want to avoid relying on one-shot, ad hoc explanations, which treat each event or situation as unique. All events are unique if we dig deep enough and describe them in their most finite details, yet as social scientists seeking to generalize from one situation to another, we are more concerned with the commonalities across phenomena than their uniqueness. Without systematic frameworks that help us categorize social phenomena, recognize commonalities across events, and enable us to generalize lessons from one situation to another, we will be at a great disadvantage in anticipating and understanding world affairs—we will always be surprised by events.

In the study of global affairs, social scientists focus on a spectrum of behavior that ranges from violent conflict to productive cooperation across national boundaries. For the most part because of my own specialty, this book tends to focus on international political economic relations, not on war. But cooperation and conflict are related as two sides of the same coin. The explanatory frameworks or mechanisms of political behavior should be similar regardless of the phenomenon we want to understand—whether conflict or more cooperative outcomes of economic exchange. If politics are politics, then the same explanatory frameworks should operate in a variety of situations, domestic or international, in war or peace. The settings may shift, but the theories and tools we use to account for political behavior should remain relatively constant. This approach explicitly assumes that similar processes and mechanisms are at work across the different fields of political science and that the boundaries separating the different fields—such as comparative politics and international relations—are artifacts of organization and specialization, not differences in explanatory mechanisms.

Social scientists engage in a variety of activities: description, explanation, prediction, and prescription. In this text I emphasize the task of explanation, use description, and largely neglect prediction or prescription. Social scientists engage in all these activities as part of their discipline, but they tend to specialize and focus more heavily on one activity over the others. In the pursuit of explanation, social scientists employ a variety of theoretical frameworks as they explore the range of human activity. In political science, multiple, or competing, approaches robustly coexist, as no single unified explanatory or theoretical framework has prevailed. In any science, explanatory approaches become more prominent or fade depending upon how they perform relative to alternative approaches. First, let's consider what I mean by *science* in this book, and then proceed to define the activities that constitute its practice.

Social Analysis as Social Science

Science is about the process of research. Unlike physical and life scientists who practice bench science in laboratories, and often under controlled conditions, day-to-day activities in

the world and history serve as the dominant laboratories for social scientists. They rarely have the luxury enjoyed by many physical and life scientists to conduct experiments in controlled laboratory settings where all inputs are carefully measured and one input (called an intervention or independent variable) can be varied at a time so the scientist can then look for a change in outcomes (the dependent variable) that can be attributed to the change in the input, or independent variable. A controlled laboratory setting allows the scientist to insulate the experiment from other inputs that could affect the outcome. This control of the experimental environment and of the intervention allows for more comfortable assessments about **causality**, or whether the change in the input *A* actually caused a change in the outcome *B*, and, if so, how much change and why. If the physical scientist worries about control of the intervention and about potential threats to causal claims, she can often design experiments to address such potential threats. For example, she can design an experiment that involves multiple groups whose members are randomly assigned; one group (the treatment group) receives the intervention, and the other group (the control group) does not. Random assignment helps to disperse preexisting characteristics in the experimental population that could influence the outcome separate from the intervention, or independent variable, of interest. Randomizing ensures that such characteristics are relatively equally distributed across the different groups, thus equalizing the groups and negating the ability of such characteristics to threaten the causal test of the experiment.

Causality is the direct connection between a cause and an effect; a relationship in which a change in input *A* brings about a change in outcome *B*.

Controlled experiments and random assignment are powerful tools in the design of research, but they are tools that are often unavailable to social scientists. Unfortunately, relatively small portions of the phenomena that most of the social sciences seek to understand are conducive to experimental research settings, and, even then, questions remain about the applicability of the research findings to the nonexperimental world. Instead of sterile and controlled experimental settings, the current world and history serve as the settings where political scientists explore and test their theories. Political scientists obtain some of their data from controlled laboratory settings, but most of their data come from uncontrolled research settings such as the forensic probing of past and current events, the conduct of elite and mass interviews and opinion surveys, exploration of historical archives, examination of government reports of economic and social statistics, analyses of media reporting, consideration of legislative voting behavior, and other activities that occur outside the laboratory.

The absence of control by the researcher means that she cannot assign an intervention to a particular group and not to another, nor does she get to distribute the subjects being studied (governments, decision makers, voters, businesses, and so on) among the different groups. For example, political scientists do not designate some people to live under authoritarian regimes and others to live under democratic regimes in order to evaluate the effects

of regime type on citizen behavior; they do not assign war to some nations and not to others in an effort to determine the effects of war on society; they do not impose economic recession on some societies and not on others so as to examine the influence of economic downturns on political and social behavior; and they cannot lower barriers to international trade in some societies and not in others in order to evaluate the impacts of free trade on domestic politics.

The lack of control and assignment by political science researchers creates tremendous obstacles for analyzing and testing causal relationships, which can affect the strength and confidence of their causal claims. Unlike the laboratory researcher, who can control or manage many outside forces that might affect an experiment, the political scientist generally has no such control—which makes it far more difficult for her to assert confidently that *A* causes *B*. Self-assignment by the subject or the phenomenon being studied creates a possibility for selection bias, which can contaminate a causal claim. The reason a state, society, organization, or individual is in one category or another may be found in some underlying characteristic that causes the outcome of interest and not the independent variable of interest. Consequently, social scientists must often take greater leaps of faith in making their causal claims than physical and life scientists do. Recognizing this absence of control is not to belittle the endeavor of social scientists or the results of their research; rather, it highlights the greater obstacles that social scientists encounter as they undertake their tasks.

Already a tough challenge owing to the lack of control over the research setting, the process of social science is further complicated by an additional factor: the subjects of social science research, human beings, exercise choice. At least on the surface, they change their minds. One day a person eats fish, another day, chicken, and another day, meat. In one election a person votes Republican; in another, Democratic. A policy maker who claims to be a proponent of free trade may promote freer trade in one industry but advocate trade protections in another. Physical laws governing the bonding of chemical elements, chemical reactions, movement of objects through space, behavior of neutrons and electrons, or genetic patterns appear immutable—or at least the physical scientist can specify under what conditions the relationships dictated by the laws of nature do not hold. Social scientists are far from being as successful as physical scientists at creating general laws of behavior in their fields, or in specifying under what conditions those laws do or do not hold. Ironically, perhaps the only successful overarching law of behavior in the social sciences is the one that states how difficult it would be to generate such laws.

Despite the differences separating the physical and life sciences from the social sciences, there are tremendous similarities across the two spheres that make them sciences and separate them from the humanities. I emphasize four key similarities here: *the is versus the ought*, *systematic and rigorous exploration*, *cumulative progress*, and *generalizability versus uniqueness*. The difference between the *is* and the *ought* is simply the difference between how the world does work and visions of how we want it to work. How we desire the world to work is

a **normative** statement. Our individual visions of an ideal world are loaded with our individual values. How the world actually operates is a **positivist** statement, regardless of whether we like the outcomes or not. The *ought*, the ideal, can and will vary from person to person, but how the world does work, the *is*, does not—although as individuals we may have different interpretations of that reality. One of the objectives of positivist social science is to limit those different interpretations. This contrast underpins the difference between **positive theory** and **normative theory**. Normative philosophers emphasize the *ought*. Physical and social scientists both care about the normative state of the world—they have preferences about how the world should be, but their basic research generally attempts to explain what does happen, not what ought to happen. Positivist scientists engaged in basic research strive to uncover the *is*. Sometimes this distinction can be uncomfortable for investigators, as they discover that the world operates in a manner contrary to their normative preferences or values. But changing such undesired outcomes in the world requires understanding the mechanisms that produce those outcomes.

Both physical and social scientists seek to explore the world systematically and rigorously in an attempt to develop causal understanding of physical and social phenomena, respectively. They seek to build and test causal explanations about how the world works in their particular areas of interest. Systematic, rigorous exploration involves clear and explicit statements about how one set of factors, known as **independent variables**, relates to another factor, the **dependent variable**, or how and why change in the independent variables may cause shifts in the dependent variable. This systematic positing of relationships differs significantly from simply asserting or demonstrating a relationship. It involves construction of a logical formulation of how one set of factors relates to another—a causal path. There are crucial differences between establishing causality and discovering an association or correlation between one set of factors and another. *Correlation* suggests only a connection between different factors: it tells us that factors covary in relation to each other, but not why they covary. *Causality* requires more than demonstration of a covariance: it is an attempt to tell *why* factors covary in relation to each other.

Claims of causality require a story, a theory, that links the independent and dependent variables. For example, since the end of World War II, the expansion of international trade is positively associated with economic growth. This is a descriptive statement that tells us that trade covaries with economic growth, but it does not tell us why. Within this simple statement of association, we lack a story that explains whether trade causes economic growth, whether

Normative refers to how we desire the world to work in the ideal. Individuals are likely to have different normative outlooks on the world. **Positivist** refers to how the world actually operates regardless of whether we like that world or not. **Normative theory** is a statement about how we want the world to work, what “ought to be.” **Positive theory** is a model for how the world actually works, “what is,” rather than how we might want the world to function.

The **dependent variable** is the phenomenon or outcome that a social researcher is attempting to explain, a factor that is influenced or caused by an independent variable. **Independent variables** are factors that, when changed, cause a shift in another factor (the dependent variable).

growth causes trade, or whether, perhaps, the relationship is simply **spurious**—the two factors really are not related, and just by happenstance they covary. Now, if we say that trade exposes

Spurious refers to a false association, such as when two or more phenomena seem to covary yet there is no direct causation or any real underlying association. This can be the result of coincidence or perhaps an unseen factor that is associated with the phenomena that appear to be associated.

producers to greater competition that disciplines production and encourages economic specialization and economies of scale, then we have a plausible causal story that tells us why trade contributes to economic growth.

A scientist, physical or social, has the responsibility of developing and considering competing explanations, alternative theories, and causal paths. Positing a causal relationship is only part of the process; another

part is the systematic and rigorous empirical testing of that posited relationship. This testing is critical for evaluating the validity of the posited causal explanation—for evaluating the *is* versus the *ought*—and for selecting among a variety of plausible but competing explanations of the same behavior. The scientific process—the rigorous design of empirical tests of competing theoretical arguments—does not actually prove theories as much as it disproves them. The rigorous design of empirical tests helps to rule out some explanations and increases confidence in others. Such rigor is clearly more difficult for social scientists than for physical scientists, for the reasons discussed earlier.

Both physical and social scientists seek to develop cumulative bodies of knowledge and understanding that build and improve upon previous work. This focus reflects the fact that science is an ongoing, progressive enterprise. New generations of scientists build upon the foundations established by the work of past researchers, developing a body of knowledge that contributes to future research and understanding. This cumulative effort differs from the endeavors of the arts and humanities. For example, our drama is not better than Shakespeare's or our art better than that of Rembrandt or Michelangelo, just because we have had centuries to build upon their work. But if we are successful as scientists, our physical science is better than that of Galileo Galilei, a seventeenth-century astronomer, and our social science is better than that of Max Weber, a German sociologist of the late nineteenth and early twentieth centuries—even if they might prove to be better investigators than we are if we could transport them through time to the present.

Finally, physical and social scientists concern themselves with their ability to generalize from one relationship or phenomenon to others. They search for commonalities across phenomena as opposed to the uniqueness of such phenomena. A social scientist may study a particular case, but she does so in the hope that by understanding the specific case she can generalize the findings and so extend her understanding to other cases and settings. Social scientists seek to be able to generalize from one setting to another. Theory and empirical testing provide the backbone of this process. Social scientists engage in empirical testing of theories in multiple settings, seeking to reproduce their findings in support or rejection of given theories, but always with the goal of finding robust explanations of human behavior that work in a variety of settings. Students of the arts and humanities may revel in the

uniqueness of a phenomenon, but social scientists relish the discovery of characteristics that undermine claims of uniqueness and distinctiveness.

Tasks of Inquiry: Describing and Explaining What Happened and Why

Now let's turn to the four tasks of social science: description, explanation, prediction, and prescription. *Description* is the process of telling *what* happened; it is a recounting of events. Those engaged in description act as storytellers and perform a great service. Without description we do not have a history of our past or a good understanding of the contexts in which we operate. Without such understanding, our choices are more likely to prove dysfunctional, even pathological. Those engaged in the endeavor of description may implicitly convey a story about *why* something happened or the causality of the event in question, but the process of description does not explicitly require an explanation of why something occurred. Descriptions in world politics tend toward highly detailed accounts of how the participants behave. By their focus on particular events, descriptions often emphasize the uniqueness of events and behavior. Journalistic accounts of world affairs generally fall into the category of description. This text engages in some description of global political economic relations (in Part III) to provide context for evaluating and using tools of explanation.

Introducing tools of *explanation* is the primary goal of this text. As political scientists interested in global affairs, we want to know *why* certain phenomena occur—such as war, peace, growth, development, democracy, financial distress, trade barriers, alliances, international investment, migration, and environmental decay—not simply *what* occurs. Explanation is the process of trying to understand the causal relationship between independent and dependent variables. We hope to understand why and how changes in the independent variables will produce changes in the dependent variable. Simply asserting a relationship between independent and dependent variables does not constitute an explanation, only an association. Explanation is the goal of theories that link the dependent variable to the independent variables. Such theories are attempts to make sense of why people behave the way they do in specified settings, or why they make the choices they make under specified conditions. A good theory is logically constructed, which means that each step of the theory, a step along a causal path, attempts to follow rigorously, logically, and consistently from the previous step. This deliberate progress contrasts with ad hoc or off-the-cuff argumentation, which amounts to assertion, even if intelligent assertion.

Another term for theory is **model**. By definition, models or theories are simplified intellectual constructions that propose relationships. By simplifying or extracting core, primitive relationships among variables, models provide tools for recognizing similarities across social behavior. This process may enable us to generalize our discoveries about social behavior in one setting to understand similar behavior in another setting. In an incredibly complex world, loaded with information and noise, models help us determine where to look,

A **model** is an intellectual construction that postulates a causal relationship across a set of variables, thus providing a tool for examining similarities across social behavior. By definition a model is a simplification of the world being examined.

what to ignore, and what to expect. They establish frameworks for collecting, connecting, and evaluating information about the world and then interpreting events. They help us distinguish important from trivial information. Sometimes our models are wrong, and we overlook or misinterpret important information. If our models prove consistently inaccurate and unhelpful, then we seek to construct new models. But if our models prove useful and stand the test of continual reexamination and application, then we gain confidence in them.

Multiple explanations are plausible and likely for almost any interesting social behavior. How do we choose among competing explanations, particularly if several seem plausible? Political scientists evaluate models of political behavior by examining their theoretical construction, but also through empirical testing. At a theoretical level, we assess the plausibility and usefulness of a model's assumptions and its internal consistency and logic. Empirically, we test a model's **validity**, or how accurately the model reflects the actual relationship in the laboratory of the real world. As mentioned earlier, this is generally a more

Validity is the accuracy of a model or claim. **Testable hypotheses** are assumptions about behavior that can be evaluated with information from the empirical world. **Data** are information, quantitative or qualitative, that can be applied to a question of interest.

difficult laboratory than the typical controlled laboratory setting enjoyed by physical scientists. Political scientists rarely have direct control over the settings or the range of factors that can influence human behavior. Consequently, in most cases the political scientist's conclusions about causality are necessarily weaker than those of physical scientists. Within the constraints of such lower expectations, does a model do well at explaining what it claims to explain? How does a model fare in comparison with other models? Good theories produce **testable hypotheses** or conjectures about behavior that can be evaluated with information, which we call **data**, from the empirical world. Data can be quantitative or qualitative. Investigators can compare expectations produced by the different models and then use empirical tests to select among competing explanations. If they are successful, other researchers can build upon their findings, creating a cumulative body of research and knowledge. Good scientific investigation requires constant reexamination and the creation of opportunities to be proven wrong. Testing and retesting the same logic across multiple settings helps to reject some explanations for social behavior and can build robust explanations that are cumulative and serve to advance our understanding of social behavior.

Whereas description is a process of telling what happened and explanation is the task of telling why it happened, *prediction* is the process of telling what will happen. Prediction is a primary concern for those engaged in policy making. Policy makers want to know what is going to happen, with the goal of being able to affect what happens or at least gain some warning so they can prepare to manage the consequences. Soothsaying, fortune-telling, and divine prognostication are forms of prediction, but not the type meant here. Prediction for a social scientist is more than a random, unsystematic, mystical gaze into the future. For a social scientist, prediction is based upon systematic frameworks or models of human behavior. Like the logically and systematically derived hypotheses used to test models of

explanation, predictions derive from such models—implicitly or explicitly. The testing of models of explanation can engender confidence that translates into predictive capabilities of the successful models. Sometimes we use the past to test the predictive capacities of our models. Yet, the fact that we have identified good predictive models does not mean that we necessarily know why things happen. Nor does understanding why things happen necessarily produce good predictions. As E. B. White wrote in 1948:

The so-called science of polling [*a favorite activity of many political scientists*] is not a science at all but mere necromancy. People are unpredictable by nature [*the effect of choice*], and although you can take a nation's pulse, you can't be sure that the nation hasn't just run up a flight of stairs, and although you can take a nation's blood pressure, you can't be sure that if you came back in twenty minutes you'd get the same reading. This is a damn fine thing.²

Finally, some social scientists engage in *prescription*, or the advocacy of specific policies for implementation. This activity separates those social scientists engaged in basic research from those in applied work, distinguishing those who try primarily to understand why things happen from those who work to change what will happen. These tasks are not independent, but collegial. The most effective prescription builds on understandings of causal processes that are illuminated by those engaged in the task of explanation. Knowing why things happen, the causal path, can give applied social scientists and policy makers valuable insights about where and how best to intervene to alter social outcomes, about where and how to use scarce resources to change behavior in societies. Prescribing policy without some systematic notion of the underlying processes is little more than random prescription, or throwing money at problems. Yet this may be the best that policy makers can do in some situations, given the difficulty of uncovering the root causes and mechanisms of complex social behaviors.

TWO EXAMPLES OF THEORETICAL FAILURES: LIBERALISM AND REALISM

Our journey to develop the political scientist's theoretical toolbox requires that we quickly outline, evaluate, and discount two popular and prominent approaches, realism and liberalism, that have dominated the teaching of international relations and international political economy for decades. (*Liberalism* as used here refers to the processes of market exchange and not to a position on the left-right spectrum of politics.) While realism and liberalism are useful theories up to a point, it should quickly become evident by the yardstick of what we

²E. B. White, "Polling," *New Yorker*, November 13, 1948; bracketed italics added.

have defined as science that excessive reliance on these is bad social science if part of our endeavor, as scientists, is to test our theories continually against the empirical world in order to reject theories that fail to provide useful analytical leverage over important social behavior. This is important not simply for academic musing and as part of the normal progression of science, but because these frameworks are used to inform policy deliberations that affect the lives and welfare of individuals and their communities. Two examples will illustrate the significant shortcomings of realism and liberalism to explain international political behavior, enabling us to move on to develop a framework that is more useful.

Liberalism: The Mutually Beneficial Exchange of Trade and Globalization

In 1930 Congress passed the Smoot-Hawley Act, the last general tariff adopted and implemented in the United States. Almost since the founding days of the Republic, tariffs (trade barriers that increase the cost of imports by imposing taxes on them) had been a focus of much congressional activity. Until the passage of the constitutional amendment enabling the income tax, tariffs had been a major source of federal government revenues. Debates and divisions over trade policy colored early U.S. history. Shortly after the country's founding, Alexander Hamilton endorsed trade protections as a tool to stimulate economic activity in nascent American industries. In the latter 1800s, the issue of tariffs became a significant source of conflict between Republicans and Democrats, with the Republicans generally favoring tariffs and the Democrats pushing to lower trade barriers. E. E. Schattschneider, a political scientist whose research on U.S. politics in the mid-twentieth century was seminal to the development of political science as a science, wrote that "the history of the American tariff is the story of a dubious economic policy turned into a great political success. The very tendencies that have made the legislation bad have made it politically invincible."³

The Depression-era bill, named for its creators, Senator Reed Smoot (R-Utah) and Representative Willis Hawley (R-Oregon), imposed tariffs on more than twenty thousand imported goods and raised tariff rates to their highest level in U.S. history. Many political scientists and economists view the Smoot-Hawley Act as among the most damaging interventions by government into the economy—and one of the worst pieces of legislation—in U.S. political economic history. They argue that the Smoot-Hawley tariffs added to the depth and duration of the Great Depression. Because of the position of the United States as the largest and richest political economy in the global arena, U.S. policy choices such as Smoot-Hawley spilled across national boundaries and influenced economic, social, and political activity in other countries, in this case causing unemployment and economic distress among other nations' laborers and producers.

Other governments, seeking to address the contagion of economic ills wrought by Smoot-Hawley on their constituents, retaliated by raising their tariffs and trade barriers.

³E. E. Schattschneider, *Politics, Pressures and the Tariff* (New York: Prentice Hall, 1935), 283.

Over the next several years, impediments to international exchange continued to increase, and the volume of world trade declined drastically. As imports and exports fell, the economic activity associated with those imports and exports also declined. The decline in trade slowed economic activity, added to economic uncertainty, cut off avenues for expansion and recovery, and fed the social and political dislocations of the Depression years. Political parties on both the extreme right and the extreme left took advantage of the economic distress to build support among the disaffected and so advance their political agendas. Hitler, Mussolini, Franco, and others mobilized widespread popular discontent to take command of their respective governments. World War II followed. Certainly other factors contributed as well, but the breakdown in the processes of globalization abetted by the Smoot-Hawley tariffs played a major role in the progression of events leading to the war.

Liberalism, one significant approach to international relations, argues that trade and the processes of globalization constitute a win-win situation for all parties engaged in exchange. Since David Ricardo's seminal essay on the political economy of foreign trade in 1817, economists and policy makers had come to understand and recognize the consequences of comparative advantage in international trade and its ability to improve the aggregate welfare of societies that participated in international exchange. Economists had come to accept as law the pure utilitarian gains that trade provided: overall, societies benefited from more—not less—trade, regardless of the circumstances. The precepts of liberalism demonstrated that trade in all situations would lead to an enlargement of market exchange. This would expose producers and labor to greater competition, which would condition the productive forces of societies, enable greater gains from specialization, lead to more efficient use of productive resources, and enlarge the consumption possibilities of those in society—essentially increasing their real incomes. Paul Samuelson, the first American to win the Nobel Prize in Economics and one of the preeminent economists of the twentieth century, called comparative advantage the only big idea that economics produced that was both nontrivial and surprising.

Why would two Republican members of Congress propose legislation that rejected common knowledge and produced such damaging outcomes? Why would other Republicans support this legislation? Why would a Republican president, Hoover, sign it into law? And why would U.S. society tolerate such antitrade practices, which would predictably damage the nation's social welfare—raising prices for consumers, limiting their consumption possibilities, and effectively lowering their real incomes? Why would the United States—a country that professed a belief in market exchange and the mechanisms of capitalism—adopt such high levels of tariff protection when such policies intervened in market exchange, reduced the efficiency and gains from market exchange, and threatened the welfare of its own people?

We cannot claim that the Republican supporters of Smoot-Hawley were ignorant of economic arguments against government intervention in market exchange and against their legislation in particular. After all, they were members of a political party that had for decades been unabashed supporters of laissez-faire capitalism and limited government intervention

in the economy. The Republican Party represented the business and economic elites who strenuously resisted government intervention in domestic economic activities. With some exceptions, such as Teddy Roosevelt, the Republican Party reliably championed corporate capitalism against the interests of labor and small enterprise, as Republican business elites fondly embraced the tenets of social Darwinism and the survival of the fittest in economic affairs. Moreover, in case these Republican legislators had a temporary brain freeze and had forgotten the connection of trade to market exchange, more than one thousand economists, including all the top experts, signed a letter imploring Congress to reject Smoot-Hawley and asking President Hoover to veto the legislation. Why, then, would policy makers favor policies that they knew would limit the gains to their society, and even potentially harm it?

Moreover, this intervention by the government in market exchange was not an unusual event. Earlier in the decade a Republican-dominated Congress had passed the Fordney-McCumber Act, which increased tariffs on agricultural imports. As Schattschneider noted, tariffs had been an enduring part of U.S. economic policy for much of U.S. history, despite the awareness of the aggregate social welfare gains from trade. Republican support for tariffs had a long history. Following the Civil War, a partisan divide had emerged over tariffs, with Republicans generally supportive of and Democrats usually more opposed to such measures. We cannot argue that Democrats actually understood market economics and the purported benefits of capitalist market exchange better than Republicans did during this period. As mentioned earlier, many influential Republicans had long been forceful proponents of laissez-faire capitalism and social Darwinism—whereby the discipline of free market exchange created economic winners and losers, rewarding the winners and forcing the losers to adjust their economic activity. In contrast, many leading Democrats had advanced a populist and more progressive agenda, which advocated using the tools of government to constrain laissez-faire and corporate capitalism. Given this history, Democrats would seem more likely than Republicans to advocate government intervention to rein in the harshness of social Darwinism and to cushion workers and small businesses from the potential violence of the rapid adjustments generated by market exchange.

The framework of liberalism provides no explanatory mechanisms to account for such seemingly socially perverse choices. Did Senator Smoot and Representative Hawley set out intentionally to damage the national economy and destroy the global economy, prolong the Great Depression, and generate conditions conducive to another world war? Unlikely! Should we conclude that Smoot, Hawley, other members of Congress, and the president all elected to act irrationally at the very same time to endanger the global economy at a time of great fragility? No! But this explanatory dilemma highlights weaknesses in liberalism as a theoretical framework for understanding important processes and events in international affairs. The moving parts of the theory of liberalism cannot account for such devastating choices by informed and intelligent policy makers. Smoot-Hawley and other similar policy choices are not trivial problems for the explanatory framework of liberalism. Problems in this framework might be overlooked if they produced only minor problems, but the

resulting problems are often not minor. In the case of Smoot-Hawley, the resulting decline in trade fed the depth and duration of the Great Depression, which led to the political extremism that underpinned the downhill slide into World War II, during which approximately fifty-five million people perished.

Schattschneider wrote that the conditions surrounding bad economic policy such as the tariff actually made such policy “politically invincible,” or undefeatable. He argued that the institutional makeup of the U.S. political system promoted the tariff despite its poor economic policy prospects. U.S. political institutions—“the rules of the game”—structured political bargaining and the partisan divide in a way that made elected representatives amenable to flawed public policy such as Smoot-Hawley. This explanatory framework provides a mechanism where the independent variables—the institutional setting of U.S. politics—produce a decision-making context where public policy makers might rationally and intelligently select a policy that is inconsistent with the precepts of liberalism. Liberalism has no mechanisms to explain such a seemingly contradictory choice. It lacks those independent variables or moving parts. Schattschneider’s explanation suggests that we would still be burdened by these poor policy choices if the rules of the game, the political institutions, had not changed. And in 1934, Congress did indeed pass legislation that changed the rules of the game. The Reciprocal Trade and Tariff Act (RTTA) was an institutional reform that shifted some responsibility for U.S. tariff levels to the executive branch. Congress gave the president the ability to unilaterally negotiate and adopt reductions of up to 50 percent in existing tariffs without consulting lawmakers. The president could not impose new tariffs, for that prerogative rests constitutionally in the power of the House of Representatives to create taxes, but the president could now reduce existing tariffs within the guidelines established by Congress. This new rule started a long decline in U.S. tariff levels and a liberalization of access to U.S. markets. Given the size of the U.S. economy and its position in the global economy, this trend helped promote an expansion in international exchange and contributed to an increase in global social welfare. Within the space of four years, the United States had adopted policies diametrically opposed to Smoot-Hawley.

In this historical example, we encounter many of the broader topics that are the focus of this book. First, a government enacts a policy—Smoot-Hawley—that is inconsistent with its society’s long-term welfare, although another policy would produce a better outcome for society as a whole. This policy making produces a suboptimal collective outcome, which we call a *social trap* or *political market failure*. Second, there is breakdown in economic market exchange as international trade declines precipitously, which we call an *economic market failure*. Third, as we noted, the U.S. government is divided along partisan lines, which reflect *cleavages* that can produce different coalitions and alignments of interests in domestic society. Fourth, we see the importance of the rules of the political game, which we call *institutions*. A dramatic change in the rules of the game from the 1930 Smoot-Hawley Act to the 1934 RTTA provided an opportunity to observe the consequences of institutional change, as Schattschneider’s politically invincible tariff became vulnerable. Finally, all of these

observations concern activities and actions that originate within a specific political economy, and yet their consequences spill across borders to influence other political economies and the global arena itself. We cannot account for any of these activities using only the framework of liberalism, as the key explanatory components are missing. We will revisit liberalism, especially in chapters 3 and 4, as it will provide a baseline for recognizing and evaluating political and economic market failures.

Realism: The Nation-State System and the Distribution of Power

Now let's turn to another influential theory in international affairs, **realism**, or **realpolitik**. Realism uses only a few moving causal parts, or independent variables, to explain behavior in the international arena. Realism focuses primarily on the structure of international relations—the nation-state system—and the distribution of power or capacity to exercise influence in the international arena. Since the Treaty of Westphalia in 1648, relatively autonomous political units called nation-states have dominated the political organizational and structural landscape of modern international affairs. This does not mean that international affairs involve only nation-states, just that nation-states have been the primary and dominant form of political organization in world affairs since the advent of the modern nation-state system in 1648. The governments of these nation-states purportedly exercise exclusive authority, which is known as **sovereignty**, over their domestic affairs. Theoretically, this authority is free of intrusions by other governments or societies. This is a creative fiction that is sometimes observed when useful but is frequently violated, especially with the advance of globalization that links societies together. Moreover, this system lacks any centralized authority that overarches the decentralized nodes of political authority resting in the hands of the governments of these nation-states. Despite the presence of an organization such as

Realism, or **realpolitik**, is an approach to international relations that emphasizes the reliance of governments on their own means, rather than on international treaties and law. It focuses on power, self-help, and material outcomes, rather than moral constraints to address a world of what is, not a world of what ought to be. **Sovereignty** is the principle that the government of the state is the supreme legitimate authority within its territorial borders; in terms of international relations, it means that, theoretically, no state can exercise legitimate authority within another state's boundaries. **Power** consists of the tools, the means, to influence outcomes and achieve one's own ends; it is the ability to prevail and overcome.

the United Nations, there is no government to govern the governments of the nation-states. The nation-state system lacks any overarching authority or binding international law with credible enforcement mechanisms to mediate and resolve disputes between countries, to punish those violating the rules of the game, or to manage uncertainty and constrain governments. Political scientists have labeled this structure a state of *anarchy*.

This anarchical structure of international political relations creates a dilemma for governments in terms of advancing their societies' needs. They must rely on their own capacities, or what we call **power**, rather than on international treaties and law. So realism is defined by the structure of political organization that creates a *self-help* system. This

structure is one key explanatory variable in the theory of realism. The ability of governments to engage in self-help, which we lump together under the category of power, constitutes a second key variable in the theory. Not all governments have the same capacity to exercise power. This leads to another variable, or explanatory moving part, called *hierarchy*. Hierarchy is defined by where a government's capacity to exercise influence stands in relation to the capacities of other governments in the nation-state system. Realists attempt to use these three moving parts—structure, power, and hierarchy—to explain behavior in the international arena such as conflict, competition, cooperation, the forming of alliances, and the forming of trade relationships.

Realists make no assumptions about the beneficence of others or about the reliability of international legal obligations in the context of anarchy. Realists assume that governments will use their self-help tools, or power, to survive and, they hope, prosper, perhaps at the expense of others and regardless of any normative notions of morality and humanity. Their ability to do so is conditioned by their position in the international hierarchy of such self-help abilities, or power. This may seem like a pessimistic view of human behavior, but realism does not preclude cooperation, prosperous coexistence, and normatively desirable outcomes. Instead, it argues that obtaining such outcomes requires governments to recognize the proclivities of others and to act to constrain activities that can undermine such outcomes. For realists, the ends justify the means. Realism is a strategy for dealing with the state of anarchy in international affairs. The state of anarchy may describe a world of disorder within a brutal state of nature, a dog-eat-dog world where conflict and disorder are ever present, or it may describe a world of order and stability, an arena characterized by cooperation and agreement. The framework of realism suggests that the differential abilities of states can actually produce a hierarchy among states, generating a structure within the state of anarchy. The mechanisms of power and hierarchy in the theory of realism may provide a means by which order can exist in such a self-help structure, allowing states to engage in cooperative and peaceful exchange, resolution of disputes without violence, and compromise.

Realism assumes that goal-oriented policy makers will not knowingly opt for policies that damage their states' survival, their states' positions in the international hierarchy, or their states' abilities to prevail in international affairs. This suggests that decision makers should opt for policies that address threats to their survival or could affect their positions in the international hierarchy. Any other policy choices would be outside their national interests as defined by the moving parts of the theory. This approach has many merits. It is elegant and simple. In addition, realism highlights the structural dilemmas of the global arena, but it falls short of being able to account for many important outcomes in world affairs for many of the same reasons that liberalism is flawed. Its moving parts cannot account for important behavior in global affairs.

For example, realism cannot account for U.S. involvement in the Vietnam War, or its outcome. In the context of realism, why would a superpower at the very top of the international hierarchy (in terms of capacity) engage in a conflict with a peasant economy far down

that international hierarchy? North Vietnam was not a threat to U.S. survival, or to the U.S. position in the international hierarchy. Nor could the United States improve its position in the international hierarchy by engaging in a conflict with Vietnam. Moreover, given the critical moving parts of the theory—the capacity for self-help and position in the international hierarchy—how can realism account for the United States losing the conflict? This loss was apparent to U.S. policy makers as early as the mid-1960s, as revealed by the tape-recorded conversations between then Secretary of Defense McNamara and President Johnson, and by the memo sent by Assistant to the President Patrick Moynihan to President Nixon in April 1969, in which he wrote, “Unless I am mistaken, America has ‘lost’ its first war. Four years, \$65 billion, and 212,022 casualties have not enabled the most powerful nation on earth to overcome the resistance of a vastly out-gunned, out-numbered enemy.” Were U.S. policy makers simply misinformed about the stakes, or could some other theoretical approach perform better in accounting for U.S. policy choices? A similar theoretical failure applies to the Soviet invasion of Afghanistan in 1979, which ended with failure and the withdrawal of the final Soviet troops in 1988. Again, the Soviet Union was one of the two modern superpowers, sitting near the top of the international hierarchy, and Afghanistan was far down the international hierarchy. In terms of the moving parts of realism, what could a successful or unsuccessful war do for the Soviets in terms of their position in the international hierarchy, and how could they possibly lose? Realism cannot account for either the choice to go to war or the outcome. Can another approach to political behavior do better? Let’s turn to a more recent case that illustrates the shortcomings of realism.

On September 11, 2001, terrorists hijacked several U.S. commercial airplanes and flew those planes into targets in the United States—the World Trade Center towers in New York and the Pentagon in the Washington, D.C., area. U.S. intelligence agencies quickly determined that a nonstate or nongovernmental organization (NGO), al-Qaeda, was behind the attacks on U.S. soil. There are many different types of NGOs in the world that play roles in international affairs—they include the International Red Cross, Doctors without Borders, the Soros Foundation, the World Economic Forum, and yes, terrorist organizations that operate across national borders. U.S. authorities knew that al-Qaeda was operating out of training camps located primarily in Afghanistan, a nation-state. An attack by one state on another state would be considered an act of war under international law, but the 9/11 attack was carried out by a nonstate actor upon a state—a murkier area in international law that led to debates over whether this was an act of war or an act of criminal violence. As the state of Afghanistan harbored the training camps and base of operations for al-Qaeda, U.S. policy makers held Afghanistan responsible for the heinous acts precipitated by this particular NGO. This is consistent with a principle in international law called *sovereignty*. The principle of sovereignty asserts that a government has the primary responsibility for its territory and that others cannot impinge on that sovereignty, which also means that a government has primary responsibility for any act that originates on its soil—whether by the government or by a nonstate actor.

Using the principle of sovereignty, U.S. policy makers asked the government of Afghanistan to arrest the terrorists for the crimes committed on U.S. soil and surrender (extradite) them to U.S. authorities. If they refused, then under the same principle, responsibility for the acts of terrorism would then also fall on the government of Afghanistan. As we know, the Taliban government of Afghanistan refused, which essentially transformed the terrorist act by a non-state organization into an act of war by one state on another. Under international law, this more than satisfied any preconditions for U.S. forces to invade Afghanistan in search of al-Qaeda and to confront the Afghan government. This was the beginning of the formal war on terror, where the full weight of the U.S. security establishment was engaged.

The war on terror that began with the attacks by al-Qaeda and the invasion of Afghanistan quickly morphed into a war in Iraq. U.S. policy makers asserted a connection between Saddam Hussein's government in Iraq, terrorism, and the threat of weapons of mass destruction. U.S. policy makers demanded that international weapons inspectors, specifically inspectors from the International Atomic Energy Agency (IAEA), have full access to Iraqi weapons facilities. This led to a tug-of-war between the governments of Iraq and the United States. Under the umbrella of a United Nations resolution and U.S. congressional authorization, U.S. forces invaded Iraq and quickly vanquished the Iraqi military and overthrew Saddam Hussein's government. Within a short time, several hundred thousand U.S. troops had boots on the ground in two land wars in the Middle East. These conflicts became the longest ongoing wars in U.S. history—longer than the Civil War, longer than World War II, and longer than the Vietnam War. They were also very costly wars in human, monetary, material, and psychological terms.

Can realism help account for the events of 9/11 and following, for the actions of al-Qaeda, for the actions of the Afghan government, and for the choices made by U.S. policy makers? In a very limited manner the answer is a conditioned yes, but realism fails to account for much of the important behavior observed. We have already noted that as an elegant and simple theory, realism makes no assumption about the beneficence of others or about the reliability of international legal obligations in the context of anarchy. Instead, realism assumes that governments operate in an international state of anarchy and will use their self-help tools, conditioned by their position in the international hierarchy, to survive and prosper, perhaps at the expense of others and regardless of any notions of morality. So realism focuses our attention on state actors, power, and hierarchy in the international arena.

The first dilemma is that there are no moving parts for nonstate actors such as al-Qaeda in the theory. In what category do we place an organization such as al-Qaeda and its actions? Of course we can accommodate realism and call the terrorists criminals. Realism does recognize that NGOs and criminal activity can exist, but it does not really have an explicit mechanism for dealing with an NGO that declares international war on states and their societies. Is it merely another NGO, an organized interest group? If so, then does it make sense for a military superpower to mobilize its entire national security establishment to combat a special interest? Right away, we see a dilemma with realism.

Second, how can we explain the actions of the government of Afghanistan? Using the mechanisms of power and hierarchy in the theory of realism, the United States clearly sits atop the international hierarchy. Afghanistan is far down the hierarchy, a thirteenth-century political economy in a twenty-first-century world. We have noted that realism assumes that goal-oriented policy makers will not knowingly opt for policies that damage their states' survival, their states' positions in the international hierarchy, or their states' abilities to prevail in international affairs. This suggests that decision makers should opt for policies that address threats to their survival or could affect their positions in the international hierarchy. Any other policy choices would be outside their national interests as defined by the moving parts of the theory. A militarily insignificant state was confronted by the demands of a global superpower. Resistance would essentially be suicidal, but resistance is what Afghan policy makers chose. They knowingly opted for policies that damaged their state's survival. We might be able to explain their decision calculus, but not within the boundaries of realism. Perhaps something at the domestic level of politics can account for their decisions, but we cannot gain much, if any, analytic insight using the moving parts of realism—system structure, power, and hierarchy. Using these moving parts, the choices of the Afghan policy makers appear nonsensical.

Third, can realism account for the actions of the Iraqi government? Ironically, the choices of the Iraqi government might be the only actions that can be explained adequately with the moving parts of realism. The government of Saddam Hussein resisted U.S. pressures and calls for international weapons inspectors, but at almost every escalation of the crisis before the U.S. invasion the Iraqi government moderated its resistance and seemed to be partially acceding to U.S. demands. The government of Iraq seemed to be playing a game of chicken with the United States, a military superpower with far greater capabilities. But the government of Saddam Hussein also seemed to recognize the differences in power and position in the international hierarchy, informed by its experience from the first Gulf War in 1991. Rather than reject U.S. demands outright and commit suicide, like the government of Afghanistan, the government of Iraq partially responded to U.S. demands at every step of the process leading up to war. The Iraqi government continually ran up to the line in the sand, but, in retrospect, it seemed careful not to cross that line. It appeared willing to make concessions to avoid damaging the state's survival. Perhaps Saddam Hussein and his advisers miscalculated, but they clearly seemed to recognize that war with the United States would be suicidal. Other theoretical approaches to political science might provide a different account of Iraqi actions—such as playing to the domestic Iraqi audience and political survival—but those actions do make sense within the context of realism. Saddam Hussein's government resisted but then made concessions at every step of the process leading to war.

Finally, can realism account for U.S. actions? Beyond having to respond to an attack on U.S. soil and defending the national space against physical attack, realism falls far short as a useful theory here. First, the attack by an NGO terrorist organization was not going to endanger U.S. power or position in the international hierarchy. Nor were the governments

of Afghanistan or Iraq capable of fundamentally damaging U.S. power or position in the international hierarchy. Perhaps we can use realism to account for why the United States initially responded to al-Qaeda and to Afghanistan for sheltering al-Qaeda, but we cannot explain the waging of decade-long wars by the United States against states far down the international hierarchy. The costs of the wars in Afghanistan and Iraq have likely done more to damage U.S. power, prestige, and position in the international arena than anything Afghanistan or Iraq could have done through rational calculation and actions consistent with realism. In many ways, U.S. actions in these cases were incredible overreactions within the framework of realism. The bargaining actions over weapons inspections and transparency by the United States vis-à-vis Iraq are consistent with realism, but the Iraqis consistently made concessions that, if continued, could have avoided outright war. Why, within the framework of realism, would the United States have elected to enter a war that would be excessively costly given its stated objectives and given the viability of other, cheaper, strategies to achieve those objectives? Furthermore, there was no indication that such a conflict would improve the U.S. position in the global hierarchy or enhance the power or prestige of the United States. Perhaps the conflict would achieve other objectives, but those do not lie within the boundaries of realism and how realism defines national interests. Perhaps other theories in political science can do better?

The structure of international relations, the capacity to influence others, and the distribution of that capacity to create a hierarchy of more to less capable governments are clearly important characteristics in international affairs (and we will examine them more carefully in chapter 2), but they are insufficient to account for many important situations in global affairs, as illustrated by the examples above. Realism neglects the political activities and strategic manipulation that can take place between individuals and groups within domestic political arenas. To circumvent such apparent discrepancies with realist theory as those illustrated above, proponents of realism often resort to ad hoc explanations that rely on independent—causal—variables that do not exist in realism. They may assign causal weight to interest group activity; variations in internal political dynamics or partisanship; domestic institutional variations across states, such as authoritarian versus democratic, presidential versus parliamentary, or winner-take-all versus proportional electoral rules; or some other factors that political scientists in the fields of American or comparative politics find influential, but these factors are not part of the explanatory framework of realism. This reliance on causal mechanisms or independent variables that are exogenous to—not included in—the theory of realism but are prevalent in other fields in political science highlights the shortcomings of the theory and suggests that we might be better served by a theory or theories that include such variables.

A theory whose moving parts frequently fail to account for significant and nontrivial outcomes that affect social welfare is of questionable usefulness and should encourage a search for alternative theoretical frameworks that perform better when tested against the empirical world. This is the forward progress and practice of good science. The practice of

good science is central to producing a better, evolving, academic understanding of social behavior, and also essential to well-informed policy making that seeks to learn from past experience and mistakes. This sets the stage for a discussion of what it is that scientists, specifically social scientists, do.

CONCLUSION AND SOME OTHER PITFALLS

In this chapter we have discussed the purposes and processes of social science. We have defined also what we mean by a micro political economy approach in this text and the three assumptions that lie at the heart of that approach, offering powerful and elegant tools to leverage our investigation and understanding of political behavior. We must remember that these are simplifications. We do not know whether political actors actually are rational and actually want to survive, but these assumptions are useful. Even with such powerful assumptions and tools, the analysis of political behavior is difficult. Strategic settings complicate the dilemma of connecting preferences, choices, and outcomes in the social world.

Several other problems also hamper this process, both for investigators trying to understand choices and for policy makers trying to make choices in strategic settings. Two of these problems warrant mention. First, decision makers generally operate under some degree of uncertainty: they have incomplete information about the world, about their possible choices, about the preferences and possible choices of others, and about how multiple decision makers' choices will interact. The games represented in figure 1.3 model interactions of complete information, in which all players know the payoffs and possible strategies; this omniscience greatly simplifies the search for preferences and dominant strategies. Dilemmas exist for decision makers even in such simple interactions, but the game becomes infinitely more complicated when

A **fallacy of composition** is a situation in which an outcome is different from what was expected based on simple extrapolation from its component parts. It may be greater or less than the sum of its parts.

a decision maker encounters a real-world strategic challenge armed with incomplete information about her choices, the preferences of others, and the structure of her interaction with others.

Second, we cannot assume that choices in strategic settings interact in linear fashion. This means that we cannot just add individual choices together to arrive at an outcome, for they may not interact additively. An outcome may be different from simply the sum of individual choices.

In this situation, which we call a **fallacy of composition**, the outcome is different from the sum of the parts: perhaps greater, perhaps less, but different. These two problems—complete information and the fallacy of composition—raise the possibility of unanticipated outcomes, which are unintentional consequences of choice. No policy maker is capable of looking down a decision path and fully anticipating the consequences of her choices and those of others. Some uncertainty about the future, some risk, always remains.

Now, as Holmes said to Watson, “the game is afoot. . . .”

APPENDIX: EXAMPLES OF COMPLETE AND INTRANSITIVE PREFERENCES

Let's examine completeness and transitivity in two scenarios, looking at preference ordering over outcomes, first by an individual and then by a collectivity or group. The latter is the more interesting and important case for societies relying on elections and markets to determine public preferences and produce social outcomes, and, as we will see, it is a problematic case for the normative qualities that many of us value in democratic societies. Since the properties of completeness and transitivity are logically consistent, relatively straightforward, and fairly easy to grasp in terms of rationality, we will intentionally construct cases wherein the preference orderings in the individual and collective scenarios are complete but intransitive. This is actually quite difficult in the individual case, but it happens fairly easily and often in the case of collectivities.

Why is this pattern of completeness plus intransitivity so difficult to illustrate in the individual case? When forced by constraints such as scarcity, individuals can usually construct a preference ordering between two alternatives that fulfills the condition of completeness, or among three or more alternatives that satisfies the condition of transitivity. This ordering process requires several simplifying presumptions that might be considered heroic. The first presumption is that individuals are well informed about the differences between alternatives and can distinguish those differences. This is a demanding criterion, but it is important for our use of rationality to examine social behavior and for the recognition of potential pitfalls of the rationality assumption. When we relax this presumption, individuals can still be rational yet make choices that appear inconsistent with rationality because of their being poorly informed or confused; they are still rational, but they are working with incomplete information. This recognition will focus our attention on the constraints of information in decision-making contexts.

For example, a wine expert should be able to rank-order two wines easily based on taste, and if a third wine were added to the tasting, the expert should be able to rank it vis-à-vis each of the other wines, so that the ordering would be transitive. If another wine were to be added, again the expert could make a paired comparison to establish completeness of preferences. The wines would all be comparable pair by pair, and when all the choices were put together, the property of completeness would also be consistent with the property of transitivity. We assume that a fully informed wine expert could produce such complete and transitive preferences. In reality, however, few individuals are master sommeliers. Most people would probably be able to do a paired comparison, comparing any two wines against each other and thereby establishing completeness, but they would likely falter in attempting to create a transitive ranking of preferences over a large number of wines. Are these nonexperts nonrational, or do they just have insufficient knowledge and experience with wine? The latter is more likely the case. If so, they are still rational, but confused by their informational shortcomings—no doubt an accurate assessment for most of us.

Our second presumption—also quite rigid—is that preferences do not change. We know empirically that tastes do change and evolve, but presuming fixed preferences is a simplifying condition that provides us with analytical leverage to examine choices. By holding this one component of the decision process constant, we can look at variations in other parts of the process and attribute variations in behavior, in choice, to those inconstant components. Presuming that preferences are constant means that the moving parts in this approach to choice are information and context. As a consequence, we look for variations in those parts to explain choices that look inconsistent with a rational decision maker's assumed preference ordering.

We can construct a situation in which an individual political actor—for instance, a judge in the European Court of Justice (ECJ), the high court of the European Union (EU)—has complete but intransitive preferences. In her deliberations, the judge weighs how her decisions affect three different outcomes: the legal process, justice for individuals, and EU integration. We can examine her preferences over outcomes for completeness by conducting a paired comparison of the weighting she gives each outcome in her deliberations. When comparing the importance of the legal process to justice for individuals, she values the process of law more than justice for individuals; we can say that legal process defeats justice. When comparing justice for individuals to EU integration, her preference for justice defeats EU integration. Finally, when comparing her weighting of the legal process and EU integration, we discover that EU integration defeats the legal process. We've established completeness, as each pair is comparable. To summarize her paired comparisons:

legal process > justice

justice > EU integration

EU integration > legal process

Yet, if we look closely at her paired comparisons, we discover that her preferences are intransitive. Rationality and the property of transitivity dictate that if she prefers process to justice, and justice to EU integration, she should prefer process to EU integration. But she actually weights EU integration over legal process in her deliberations, which means that her judicial decisions may cycle across alternatives if her deliberations involve considering the effects on all three outcomes. To her colleagues on the bench and to observers of the court who make strict assumptions about rationality, her decisions appear nonrational, poorly informed, or confused—not a good way to build a consistent and coherent body of law that will help guide social behavior. An informed observer may consider this problem manageable, however, as long as the judge's deliberations involve making a decision that will affect only two of the alternatives. This situation of intransitive preferences can be problematic for those trying to observe and understand social behavior, but it is actually quite rare at the individual level.

Unfortunately, the problem of complete and intransitive preferences can occur regularly when we are examining collective decision making such as elections and markets, which

aggregate the preferences of many individuals to produce a collective preference ordering. Therefore the second scenario, involving a collectivity's preference orderings, is much more relevant for our study of political behavior. Every democratic society adopts voting rules to aggregate individual preferences among alternatives. There are a variety of voting rules—such as unanimity, majority, plurality, and proportionality—that can transform individual preferences over outcomes into a social preference. For simplicity's sake, we use a simple majority—or winner-take-all—rule in the following, but another choice of voting rule would not make a difference in our example.

Also for the sake of simplicity, the society in our example is made up of three individuals. These three members of society, or voters, evaluate their choices among particular policies according to how the policies influence three big social outcomes: social justice, democratic rule, and economic growth. Each voter makes a complete and transitive preference ordering over these outcomes.

Voter 1 values social justice (*A*) over democratic rule (*B*),
 democratic rule (*B*) over growth (*C*), and
 social justice (*A*) over growth (*C*).

Voter 2 values growth (*C*) over social justice (*A*),
 social justice (*A*) over democratic rule (*B*), and
 growth (*C*) over democratic rule (*B*).

Voter 3 values democratic rule (*B*) over growth (*C*),
 growth (*C*) over social justice (*A*), and
 democratic rule (*B*) over social justice (*A*).

These paired comparisons produce an individual transitive ordering as follows:

Voter 1: social justice > democratic rule > growth

Voter 2: growth > social justice > democratic rule

Voter 3: democratic rule > growth > social justice

An election decided by a majority rule transforms these individual preferences into a social or collective preference. We find that social justice is preferred to democratic rule (*A* defeats *B*) by 2 to 1. Democratic rule is preferred to growth (*B* defeats *C*) by 2 to 1. So far, so good, but growth is preferred to social justice (*C* defeats *A*), also by 2 to 1. If our collective preference ordering were to be transitive, social justice would have defeated growth (*A* defeats *C*). However, the collective's preference ordering is intransitive; the outcomes of elections can cycle across the three alternatives.

The **Condorcet paradox** is a situation in which a voting rule aggregates individual preferences that are complete and transitive but produces a collective outcome that is intransitive and cycles because the preferences of the aggregated majority are in conflict with each other.

The lack of a fixed hierarchy of preferences makes society look confused or nonrational, but it is produced by individually rational behavior. This problem, known as the **Condorcet paradox**, can occur under any voting rule in a democratic society. Kenneth Arrow, a Nobel Prize winner, proved that except in a dictatorship, where only one individual

decides, any voting rule to create a social ordering among alternatives can produce an intransitive ordering even though the individuals making up the social group have complete and transitive preferences. This dilemma means that it is impossible for democratic societies to construct a social welfare function from individual preference functions. This realization opens a chink in the normative appeal of democracy, if we value democratic voting rules solely for their ability to map individual preferences accurately into a social welfare function that maximizes collective welfare. Democracy has many other appeals, however.

KEY CONCEPTS

autarky (p. 8)	globalization (p. 5)	positive theory (p. 31)
backward induction (p. 25)	hierarchy of preferences (p. 18)	positivist (p. 31)
causality (p. 29)	independent variable (p. 31)	power (p. 40)
centralized means of allocation (p. 6)	indifference (p. 18)	preferences (p. 15)
closed-economy models (p. 7)	institutions (p. 13)	realism (p. 40)
completeness (p. 18)	intransitive collective outcome (p. 19)	realpolitik (p. 40)
Condorcet paradox (p. 50)	invisible hand (p. 23)	scarcity (p. 12)
costs (p. 12)	methodological individualism (p. 15)	self-interest (p. 15)
data (p. 34)	models (p. 33)	social trap (p. 24)
decentralized (p. 6)	Nash equilibrium (p. 23)	sovereignty (p. 40)
dependent variable (p. 31)	normative (p. 30)	spatial model (p. 19)
dominant strategy (p. 23)	normative theory (p. 30)	spurious (p. 32)
fallacy of composition (p. 46)	open-economy models (p. 7)	stable equilibrium (p. 23)
game theory (p. 22)	political economy (p. 4)	testable hypothesis (p. 34)
global capitalism (p. 6)		transitivity (p. 18)
		validity (p. 34)

EXERCISES

1. What is the difference between an independent variable and a dependent variable? Give one example each of an independent and a dependent variable pair.
2. Which of the following are variables?
Foreign aid levels Barack Obama
3 percent growth Birthrates
3. Assess whether each of the following statements is a claim of causality or of correlation:
 - a. Economic growth almost always accompanies population increase.
 - b. Trade promotes peace because it increases the costs from war.
 - c. Tourism rises all over the world during the years that the Olympics are held.
4. Identify the independent and dependent variables in each of the following statements:
 - a. Knowledge is advanced by systematic research.
 - b. The more foreign aid a country receives from the United States, the more likely that country is to vote consistently with the U.S. position at the United Nations.
 - c. Low labor costs encourage the construction of U.S.-owned factories in Southeast Asia.
 - d. Authoritarian regimes discourage international investment.
 - e. The more educated a nation, the larger the voter turnout in national elections.
5. What is globalization? Give an example of global integration.
6. Why are some societies and peoples resistant to globalization?
7. What are the four similarities across the physical and social sciences that distinguish them from the humanities?
8. Why do social scientists emphasize cumulative knowledge, and how does this differ from the humanities?
9. What are the four primary activities of social scientists?
10. What do we call the analytical strategy that focuses on individual choice?
11. What do we call the state of a decision maker's preference if she must choose between two alternatives that are comparable, but she does not prefer one alternative or the other? What kind of behavior might this account for?

12. In game theory, what do we call the situation in which no player in a social interaction can improve her outcome by unilaterally choosing another strategy?
13. Consider the game illustrated below. Does a dominant strategy exist for either or both players? If so, what is it for Player 1? For Player 2?

Player 1's Choice	Player 2's Choice	
	Strategy A	Strategy B
Strategy A	2, 1	0, 0
Strategy B	0, 0	1, 2

14. Explain Nash equilibrium. Give examples of good and bad equilibria.
15. Why do political scientists use backward induction? Why is it more beneficial to look at the desired outcome than at the actual outcome?
16. Equilibria are appealing for understanding social behavior, but are they inherently good normatively? Why or why not?
17. Assume Iran and Kuwait are (the only) members of an oil cartel. Each may choose to expand or restrict its output of oil. The table below shows each side's profits (in billions of dollars) for these possible outcomes. (Iran's profits are in bold.)

Iran	Kuwait	
	Expand	Restrict
Expand	\$50 , \$25	\$65 , \$15
Restrict	\$30 , \$40	\$60 , \$35

- a. What is Kuwait's dominant strategy: expand, restrict, or depends on what Iran chooses?
- b. Which of the following outcomes is the Nash equilibrium? Both expand oil production, both restrict oil production, Iran expands oil production and Kuwait restricts, or Iran restricts oil production and Kuwait expands.
- c. Is any one of the following outcomes better for both than the Nash equilibrium? Both expand oil production, both restrict oil production, Iran expands oil production and Kuwait restricts, or Iran restricts oil production and Kuwait expands.

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The Role of Hegemonic Leadership and Its Micro Foundations

The international economic and monetary system needs leadership, a country that is prepared, consciously or unconsciously, under some system of rules that it has internalized, to set the standards of conduct for other countries and to seek to get others to follow them, to take on an undue share of the burdens of the system, and in particular to take on its support in adversity by accepting its redundant commodities, maintaining a flow of investment capital, and discounting its paper.

—Charles P. Kindleberger, *The World in Depression, 1929–1939*, 1986

In chapter 5, we noted the potential for the special case of hegemonic leadership in the international system to overcome barriers to collective action, avoid social traps, and produce mutually beneficial outcomes. In this chapter we expand our examination of hegemonic leadership. We focus specifically on a particular form of such leadership, one that embraces and promotes liberal economic exchange—market exchange—across national borders. We will examine what such leadership does in providing collective goods to the international system, assess how those collective goods influence choices and actions that aggregate to produce global outcomes, review the foundations of hegemonic capacity, and consider such leadership in historical perspective.

GROWING GLOBAL EXCHANGE UNDER A LIBERAL HEGEMON

For the past four hundred years, the rules of the global game have tended, with some interruptions, to reflect a growing preference for liberal exchange and increasing openness to the flow of goods, services, capital, and sometimes labor across national boundaries. This has unleashed the power of comparative advantage, spurred specialization across political economies, prompted economic expansion, led to improvements in overall social welfare for many communities, and advanced the globalization of economic and social relations.

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A major contributor to this dynamic has been the presence of a political economy with the capacity to unilaterally promote, manage, and stabilize a system conducive to such relations regardless of the actions of others in the international system. We call this political economy a **liberal hegemon**. Liberal hegemonic leadership has been viewed as essential for cooperative international relations that enhance social welfare and limit economic, political, and social dislocations. The Dutch from 1500 to 1700, the British from 1700 to 1900, and the Americans in the twentieth and twenty-first centuries acted as commercial and financial hegemonies during eras of expanding globalization, dominating international trade and financial affairs in the global arena and supporting the scaffolding for global capitalist exchange.

The dilemmas that hegemonic leadership helps resolve are those lurking behind many of the social traps that we encounter in world affairs and that are addressed in this book. In the nation-state system, national boundaries define the dominant political geography, yet the geography of economic activity increasingly has crossed and challenged political geography to produce a global political economy dominated by liberal market exchange or global capitalism. States and markets are two fundamentally different strategies for distribution of gains and losses—one centralized, the other decentralized. The two geographies, political and economic, can create frictions and traps that often require international cooperation in order to achieve productive economic and political relations. Such cooperation is difficult to build and hard to sustain with a political geography dominated by relatively autonomous nation-states. National policy makers encounter substantial obstacles to cooperation—temptations to free ride, uncertainty and distrust, short-term electoral pressures, incentives to engage in predatory or beggar-thy-neighbor activities, and problems of monitoring and accountability, to mention just a few.

How does such a political economy exercise its influence and support rules that promote capitalist exchange and cooperative behavior across borders? Does a liberal hegemon impose and dictate such rules of the game? Is cooperation extorted and compelled? Or does a liberal hegemon induce support for such rules of the game through more subtle, nuanced, less coercive, and, even, unintended encouragement? A liberal hegemon fosters an environment in which cooperation and liberal economic exchange are incentive-compatible for national policy makers and their selectorates. By *incentive-compatible*, I mean that such an environment and the choice to cooperate in liberal economic exchange are consistent with the preferences of the hegemon's policy makers and the preferences of policy makers and societies in other political economies.

In creating such an environment, a liberal hegemon provides a handful of collective goods that influence the cost-benefit estimations of those policy makers and their selectorates. These goods increase the gains of cooperating around liberal market exchange across borders, raise the costs of defection from such policies, reduce temptations for national policy makers to adopt policies that shift costs of adjustment to economic dislocations abroad, and help manage crises that could threaten stability and growth in the global

economy. A liberal hegemonic state essentially establishes rules of the game for global political economic affairs. Such rules guide choices and help overcome barriers to the cooperation essential for productive market exchange across borders. The rules act as constraints on choices, with the aim being to limit damaging actions and increase incentives for more socially productive choices. A liberal economic hegemon creates such rules by providing scaffolding that reduces uncertainty and risk in cross-border market exchange and interaction. This scaffolding includes collective goods that help lubricate and sustain international cooperation and socially productive economic interactions during good times while managing and limiting dislocations during bad times; such dislocations can lead to instabilities that undermine cooperation in the global political economy. A hegemonic state is that political economy with the capacity and will to bear a disproportionate share of the responsibility for providing such key collective goods.

HEGEMONIC LEADERSHIP AND GLOBAL STABILITY

For some the term **hegemony** carries pejorative connotations. Some argue that a hegemonic state leads by coercion, whereas others make a case for benevolent hegemony. This distinction is more semantic and confusing than helpful. Whether one views a state that dominates the rules of the international game of political economic exchange as coercive or benevolent likely depends on where one sits in the system, one's preference for some rules of the game and not others, and how one does or does not benefit from those rules. Rather than dwell on normative distinctions between coercive and benevolent hegemony, let's adopt a positivist and behavioral perspective to focus primarily on what a hegemon does and how. Remember from chapter 1 that positivist approaches focus on the *is*, in contrast to the focus on the *ought* in normative theory. Nevertheless, one cannot ignore the tremendous normative implications of hegemonic leadership, be they stability, cooperation, productive mutual economic relationships, growth of interdependence, expansion of asymmetric mercantilist relations, excessive rent extraction, or manipulation. These drive much of the debate over hegemonic leadership—who has it, whether it is good or bad, and, if it is good, whether such leadership is essential for the overall social welfare of the international system.

Independent of the benevolent-coercive debate, many social scientists equate a dominant state overseeing a clear and stable hierarchy among states with peace and economic expansion and, conversely, periods of uncertain hierarchy with periods of conflict and unrest. This argument about the importance of hegemonic leadership for cooperation, peace, and stability has become known as **hegemonic stability theory (HST)**. Charles Kindleberger, an economic

Hegemony is the predominance of one state over other states and the rules of the game in the system. A **liberal hegemon** is that state with the capacity to unilaterally promote, manage, and stabilize a system conducive to liberal economic relations. **Hegemonic stability theory (HST)** concerns the situation in which a capable and willing hegemonic state unilaterally provides collective goods to overcome obstacles that hinder cooperation and cross-border market exchange.

historian and one of the strongest proponents of HST, views a successful leader as one that can unilaterally establish and support rules of the game that stabilize expectations, manage risk, and promote cooperation and mutually beneficial exchange across national borders in good and in bad times. Preferring the term *responsibility* to *hegemony*, he argues that during uncertain times, when the system hits significant shocks, “for the world economy to be stabilized, there has to be a stabilizer—one stabilizer.”¹ In Part III of this book, we test conjectures about the role of hegemonic leadership and its contributions to productive globalization, economic growth, and relative peace by examining the variations in hegemonic capacity from Pax Britannica during the 1800s to the years between the two world wars of the twentieth century to the Pax Americana of the post–World War II period.

During Pax Britannica the British used their wealth, markets, and capabilities to provide key collective goods that endowed the United Kingdom with leverage to exercise global leadership, set the rules of the game, and promote a stable liberal international economic order. Kindleberger blames the collapse in hegemonic leadership following World War I for a breakdown in cooperation, reversals in globalization, and the traumatic interwar years. Under Pax Americana, the ability of the United States to establish the rules of the game and provide collective goods (militarily and economically) to its bloc during the Cold War reduced uncertainty, encouraged exchange and cooperation, and advanced a liberal international economic order that enhanced stability and growth in the postwar era.

Using such evidence, proponents of HST note that periods of sustained liberal hegemonic leadership are marked by increased international cooperation, beneficial cross-border exchange, economic expansion, accelerating globalization, and improved social welfare. They question whether, absent hegemonic leadership, states can cooperate sufficiently to ensure stable rules of the game that promote mutually beneficial exchange and cooperation in the global arena. Without such leadership, policy makers across states face heightened instability in expectations, increased concerns that their counterparts in other states might defect and adopt beggar-thy-neighbor policies that shift the costs of adjustment to economic dislocations away from their polities and to their neighbors, and calculate that by unilaterally adopting cooperative policies they cannot change the dynamic leading to destructive economic outcomes and may only increase the magnitude of the potential costs to their societies. National policy makers encounter expanding pressures to defect for short-term gains or temptations to free ride on the cooperative activities of other states. They face increasing incentives, and decreasing disincentives, to adopt policies that might enable their societies to gain at the expense of others by shifting the costs of economic, political, and social hardships abroad. After all, political leaders almost always prefer that someone else’s constituency bear the costs of adjustment during economic downturns. Such policies can spiral into a vicious

¹Charles P. Kindleberger, *The World in Depression, 1929–1939*, rev. ed. (Berkeley: University of California Press, 1986), 304.

cycle of tit-for-tat policy retaliation across national borders. This can unravel cooperation and undermine rules of the game critical to socially productive economic exchange across borders, producing greater economic volatility, heightened international social and political unrest, and perhaps even war.

This describes a classic social trap where the rational calculations of decision makers aggregate to produce socially suboptimal outcomes. These suboptimal outcomes can be avoided if decision makers can be induced to make other choices. From the perspective of HST, only a hegemon can induce such cooperation by being able and willing to overcome the free-rider problem, bearing the costs unilaterally of providing key collective goods that promote cooperation and exchange across borders—collective goods that constrain the proclivities of policy makers toward destructive economic nationalism.

LIBERAL HEGEMONS AND IMPORTANT COLLECTIVE GOODS

Kindleberger suggests that a political economy, acting as the system leader, provides five key collective goods: “maintaining a relatively open market for distress goods; providing countercyclical, or at least stable, long-term lending; policing a relatively stable system of exchange rates; ensuring the coordination of macroeconomic policies; and acting as a lender of last resort by discounting or otherwise providing liquidity in financial crisis.”² Consistent with the definition of collective goods presented in chapter 5, these collective services are relatively nonexcludable to any society that wants to participate in the global economy and follow the rules of the game. Let’s start by examining each of these five functions, and in so doing recognize that each is intricately connected to finance—provision of capital to support consumption and growth, means to settle payments, and tools to manage currency risks, trade risks, and other shocks such as inflation or deflation.

Open Market for Distress Goods

The first function, maintaining a relatively open market for distress goods, seems more like a trade good than a financial good. What is a market for distress goods and what does it do in the context of global economic growth and cooperation? It is a sufficiently large political economy that is able and willing to maintain its openness to goods from abroad even during harsh economic times. This is critical to providing an opportunity for other countries to obtain capital through the sales of such goods that might spark a virtuous cycle of economic activity and expansion. Maintaining such openness is difficult for policy makers whose constituencies face hardships themselves. Times of economic stress can raise the prospects of deflationary pressures in economies—less money chasing more goods. Imports add

²Kindleberger, *The World in Depression*, 289.

to such downward pressures on prices. To reduce such pressures and protect the prices of goods made by their domestic producers, national policy makers face temptations to raise barriers to imports—to improve the ratio of money to goods. When economic stress and deflationary price pressures affect a single state, or only a few states, the system might be able to accommodate the raising of barriers to imports in those states.

But if economic stress is systemic and the temptation to erect obstacles to imports is widespread, a situation arises where everyone may raise barriers to imports. This reduces export earnings. Drastically reducing capital inflows from export earnings can limit the capital needed to spark consumption and fuel growth—less trade, smaller export earnings, and less capital at home to stimulate domestic prices and investment. In their efforts to constrain deflationary pressures, national policy makers may participate in interactions that have the cumulative effect of exacerbating the very problems they seek to limit and trapping political economies in a vicious downward cycle—a social trap and a political market failure. By providing a market for distress goods at times of systemic stress—essentially demonstrating a costly commitment to incur at least possible short-term losses for domestic producers—a nation creates an opportunity for other nations' exporters to sell their goods into that market. This generates export earnings and expands money supply in the exporting nations. Increasing the supply of capital in the exporting nations, which stimulates demand, creates upward pressures on prices, promotes growth, and lessens pressures to erect and sustain barriers to imports. Maintaining a market for distress goods becomes a safety outlet and financing mechanism that can transform a vicious cycle into a virtuous cycle that generates growth, improves economic outcomes, reduces perverse pressures on policy makers to enact policies that can damage international cooperation, and enhances the gains from globalization. It is remarkable how insightful and robust Hume's specie flow theory from the mid-1700s remains (see chapter 3 to refresh your memory regarding Hume's theory).

Countercyclical Lending

The second function, providing countercyclical lending, is more obviously a financial tool. Countercyclical lending works with trade to help stabilize the supply of capital and the economic system. During times of economic vitality in a hegemonic economy, lenders in that economy tend to invest more at home than abroad. Through trade, capital flows into other economies in the system as consumers in the hegemonic economy increase their consumption, including purchases of imported goods. Economic slowdown in the hegemonic economy leads to a decline in consumption, which decreases the outflow of capital from the hegemonic economy via the trade mechanism. Yet such slowdowns in the domestic economy of the hegemonic state can lead to increased investment abroad as lenders from the hegemonic economy look elsewhere for growth opportunities. This is the essence of countercyclical lending. When the economy of the hegemon prospers, overseas lending tends to slow relative to domestic lending, and when the hegemon encounters a domestic economic slowdown, overseas lending expands relative to domestic lending.

Stable Exchange-Rate System

The third function, managing a relatively stable system of exchange rates, is also clearly financial. Policy makers worry about exchange-rate stability because it affects their domestic prices, the competitiveness of their goods and services in the tradable sector, and expectations of risk and uncertainty in cross-border exchange. An exchange-rate mechanism that is out of equilibrium—where some currency or currencies are undervalued and others are overvalued—will produce disproportionate claims of the undervalued political economies on the overvalued political economies and pressures to redress the imbalance. This rebalancing can occur through borrowing, currency revaluation, employment, wages, or intervention in the trade arena. These pressures become more severe during hard times, when political economies face slowdowns in trade and constraints on borrowing and liquidity. At such times policy makers may seek to restore the competitiveness of their exports. Currency depreciation can become an attractive policy instrument. Policy makers rarely object if their currencies depreciate relative to other currencies, but they do worry if their currencies appreciate relative to other currencies. Consequently, competitive currency depreciation by one political economy might well incur similar responses by other political economies—a tit-for-tat beggarthy-neighbor response. Competitive devaluations could lead to chaos in the exchange-rate system, which is the worst of all worlds for trade, since uncertainty in the price mechanism affects the willingness of importers and exporters to enter into forward-looking contracts—those that are settled long after the actual transfers of goods and services occur. The ability of policy makers to manage pressures that push them to engage in competitive currency manipulation is key to the avoidance of economic conflict via the exchange-rate mechanism. Policy makers in a hegemonic economy must be able to contain and manage market pressures that challenge an exchange-rate system. Their tools include the ability to promote international coordination that reduces currency instability and the capacity to finance shortfalls in others' current accounts.



The Federal Reserve serves both as the lender of last resort for the U.S. economy and as the lender of last resort for the global economy, given the position of the United States as the hegemonic leader, or system stabilizer, for the global economy. As lender of last resort, the Federal Reserve creates liquidity in the system when no other institution or market will. In its role as the primary mechanism of U.S. monetary policy, the Federal Reserve also tries to protect the stability of the exchange-rate system.

Macroeconomic Policy Coordination

The fourth function, coordinating macroeconomic policies, involves managing monetary and fiscal policies within a hegemon's political economy and eliciting coordination of those policies across national economies. National policy makers use monetary and fiscal policies for a variety of purposes—for example, to stimulate or restrict growth, redistribute income, sterilize capital inflows, influence resource allocation, and address shocks. If used effectively, these policy levers can help produce and maintain macroeconomic stability within a political economy. Across political economies such macroeconomic coordination faces more daunting challenges. Here, policy makers can use the tools of economic statecraft, such as dialogue, diplomacy, negotiations, conferences, and treaties, as means of promoting macroeconomic coordination across borders. But through their monetary and fiscal choices, policy makers within the hegemonic state can also unilaterally help manage and coordinate macroeconomic contexts via the central position of their monetary and capital markets in the global economy and the networks created by investors and borrowers in those markets. For example, following the 2008 credit crisis that began in the United States and led to a global recession, the U.S. Federal Reserve used monetary policy to pump several trillion dollars into the U.S. economy and, consequently, the global economy. The Federal Reserve did so by purchasing financial assets from financial institutions, governments, and other entities and placing those assets in the Fed's balance sheet. At the same time, the U.S. government used fiscal policies such as stimulus programs and tax cuts to pump additional capital into the economy. Altogether, the actions of the Federal Reserve and the U.S. government added more than four trillion dollars to the global economy at a time when private holders of capital had become risk averse.

Why is macroeconomic coordination important? Macroeconomic policy choices have benefits and consequences, or trade-offs. These trade-offs can be between growth and price stability—inflation, or unemployment—or between domestic and international consequences. Such policies have the capacity to affect global stability when policy makers weigh the trade-off between the domestic and international consequences of their potential macroeconomic choices. At times, policy makers, intent on addressing conditions in their own domestic political economies, may implement policies that impose costs on other political economies. If this leads their counterparts in other states to use macroeconomic policy tools to address their domestic ills and protect their economies from such externally imposed costs, then everyone could be worse-off. If enough states focus entirely on the domestic consequences of their policy choices, independent of the interaction of those choices across national borders, this can produce a classic social trap. In this trap, rational decision makers select policies that in isolation appear likely to improve the conditions of their societies but in conjunction with choices made by policy makers elsewhere in the system have outcomes that prove mutually dysfunctional.

What makes a hegemon so important to the coordination of macroeconomic policies and constraints on national policy makers in their use of macroeconomic policies to redistribute costs abroad? Only a dominant political economy is credible enough to help coordinate

actions to avoid poor macroeconomic choices. Absent the participation of the hegemon, or possibly a small number of significant economies, the prospect for productive coordination of policies across states declines dramatically. Even if policy makers in other states want to make socially productive choices, domestically and internationally, their actions would be for naught or at least more costly absent the participation of the dominant political economy.

Lender of Last Resort: Managing Liquidity in the Global System

The fifth function, acting as lender of last resort, involves injecting liquidity during an economic downturn or crisis. During downturns, especially financial or economic crises, private sources of capital such as banks and investors in capital markets become risk averse and less willing to put their capital to work. Out of fear of the future, they seek to preserve the capital they have rather than expose that capital to risks. This shrinks the supply of capital, reduces liquidity, and raises capital costs. These are procyclical forces that can exacerbate a crisis, especially when politicians face pressures from their selectorates to provide relief when their societies encounter such downturns, even if this means implementing policies that could damage other societies and provoke retaliation that leads to greater damage to all involved. Ironically, such pressures may be particularly acute in democratic societies. Addressing the liquidity crunch is critical to breaking the downward trend, increasing the supply of affordable capital to stimulate investment and growth, and reducing pressures on national policy makers to adopt policies damaging to long-term growth and international cooperation. A lender of last resort attempts to address such shortfalls when other lenders flee. For private financial players to act as effective lenders of last resort, short-term private interests must be consistent with longer-term public interests. At times of excessive fluctuation, economic distress, and uncertainty, short-term private interests and long-term public interests can easily become time inconsistent because private lenders of last resort worry about their responsibilities to a narrower range of risk-averse owners or shareholders than a national population and over a more proximate period of time.

Given the procyclical nature of private capital, a government agency such as a finance ministry or central bank often proves the most effective in fulfilling the lender-of-last-resort function for a political economy. Compared with private holders of capital, a government serving as such a lender can draw on a broader base of capital and policy instruments to manage money supply and economic fluctuations. A public lender of last resort, whether a bank or agency, is often explicitly and formally charged with maintaining stability, managing money supply, and providing for the public interest. Its short-term preferences are to limit crises when they occur, unlike the short-term objectives of private holders of capital, who want to preserve their capital at times of dislocation. In practice, some public lenders of last resort perform better than others at representing broad public interests versus narrow particularistic interests.

A successful lender of last resort diffuses risk and increases the likelihood of countercyclical infusions of capital at a time of contraction or monetary constriction. Lenders of last resort attempt to lean against the wind and persuade private banks and investors in capital

markets to increase access to their capital during times of slowdown or decrease access at times of inflationary expansion. If such a lender succeeds in managing an economic downturn, then it works to limit wild fluctuations that concern private holders of capital, so that the private holders become increasingly willing to put their capital back to work. A lender of last resort can use a variety of policy tools to interrupt such cycles, increase liquidity, encourage holders of capital to begin lending their capital, and, ideally, constrain pressures on national policy makers to implement policies that try to improve the lot of domestic constituents at the expense of foreigners. A lender of last resort can manipulate the interest rates at which private banks borrow capital, change reserve requirements, sell or buy bonds to affect money supply, and use other means of discounting to affect money supply and credit.

A hegemonic state provides this function not only for its domestic economy but also internationally for the broader system. The lender of last resort for the international arena leans against the wind in attempting to convince private holders of capital to put their capital stocks to work and at risk during slowdowns and crises, but does so on a much broader scale and across national boundaries. Performing this function requires having private capital markets and banks integrated into global networks so that when a hegemon leans against the wind and pumps liquidity into the domestic and international arena, private capital markets and banks in the hegemonic state and in other states follow suit. The earlier example of the Federal Reserve and the U.S. government using monetary and fiscal policies to increase capital in the system dramatically following the 2008 financial crisis illustrates how a political economy can act as lender of last resort for the entire system.

SOURCES OF HEGEMONIC CAPACITY: ARISING FROM CHALLENGES TO POLITICAL SURVIVAL

What are the sources of the capacity for a society to provide such key collective goods to the system? What enables a government and society to provide the functions discussed in the preceding section, to establish and maintain the rules of the game in the global arena, and to act as the system stabilizer during periods of economic stress? Many, if not all, governments and societies would like to sit at the top of the international hierarchy, establish the rules of global interactions, and be the state that other political economies rely on during crises that threaten global social welfare. Some have tried and failed. Many countries are not even in the running. Over the past five centuries, only three political economies have gained such a position in the international system, and their success was not a matter of intentional design with hegemonic leadership as the objective. Instead, the Dutch Netherlands, the United Kingdom, and the United States acceded to hegemonic leadership as a consequence of successful domestic political and economic reforms that were responses to crises and threats to political survival in their domestic arenas. For example, the New York stock market crash of 1929 and the ensuing banking crisis that fueled the Great Depression revealed that American financial markets were corrupt and full of insider trading, and that they were arenas in which strategic

actors could manipulate price and supply. A lack of transparency and regulation favored a privileged few at the expense of the general public. Absent the crises of the 1920s and 1930s, would the rules of the game have been reformed to protect the integrity of the markets? It is worth repeating that hegemonic capacity was not an intentional construction by the governments and societies that became hegemonic leaders. It was an outcome, a consequence, of actions taken by policy makers to address dilemmas in the status quo and crises that threatened their societies' welfare and their own political survival. Societies changed because they were confronted by significant shortcomings in the status quo. Their responses were less a consequence of coherent planning than they were piece-by-piece institutional reforms scattered across a wide range of governance, fiscal, monetary, and financial areas.

Moreover, hegemonic capacity is not created in a short time and does not occur in a vacuum. It is a consequence of international investors and borrowers choosing among different states' governance and financial arrangements, rewarding successful strategies and penalizing less successful strategies. The rise of a political economy to a position of leadership rests significantly on the failings of other political economies. Reforms adopted in the Dutch Netherlands, the United Kingdom, and the United States proved successful as they were tested against the strategies and institutional arrangements of other nations. Liberal hegemony emerged as a consequence of an evolutionary process in which investors and borrowers chose among different nations' financial arrangements, rewarding successful strategies and penalizing less successful strategies. They literally voted with their contracts and capital. Success and failure were motivated by problems and objectives other than global leadership.

By now it should be increasingly apparent that the key collective functions underpinning liberal hegemonic leadership are to a great extent financial, fiscal, and monetary mechanisms. A hegemonic state provides capital to support consumption and growth, establishes a means to settle payments, and creates tools to manage currency risks, trade risks, and other shocks such as inflation or deflation. To perform these collective functions, a political economy must be sufficiently large, have access to tremendous sources of capital, and be able to influence the use of that capital to provide private and public goods to the system during economic good times and hard times. The following are four critical foundations underpinning the ability to provide such collective services: a political economy's governance arrangements, its public and private financial arrangements, the credibility of those arrangements, and the development of a global financial network around those arrangements. These four foundations affect the capacity for liberal hegemonic leadership.

PUBLIC FINANCE AND HEGEMONIC PROVISION OF COLLECTIVE GOODS

A positive relationship between sound financial arrangements and good governance is essential to productive social and economic outcomes in market economies. In *The Wealth of*

Nations, Adam Smith wrote that the Bank of England served “as a great engine of the state.”³ Nurturing and advancing this relationship was at the very heart of Alexander Hamilton’s Report on Public Credit, submitted to the U.S. Congress in January 1790. Hamilton’s report provided a rationale for the first central bank in the United States and for the development of a public debt market. His arguments prevailed despite populist opposition.

In terms of capacity, a potential liberal hegemon is a special case among those political economies where productive financial arrangements and stable governance have coevolved. Any political economy that can perform the collective functions discussed in the preceding section must have access to tremendous sources of capital and be able to influence the use of that capital to provide collective goods to the system during good economic times and bad. Here we focus on five aspects of public arrangements that underpin the provision of such functions: rule of law, taxation, public debt, lender of last resort, and willingness to expose the national currency to international use as a reserve currency and a means to settle cross-border transactions.

Rule of Law

Rule of law is a broad, overarching term. For good reason it has become a popular recommendation in the arena of development. Effective rule of law is foundational to successful development, and any political economy with the potential to become a liberal hegemon has overcome barriers to development. It clarifies and protects private property rights and consequently affects the incentives of individuals and enterprises. Viewing capital as a commodity that trades in a marketplace, rule of law delineates the ownership properties of capital and how it can be traded. It defines the responsibilities of borrowers and lenders, which are key to the incentives to accumulate, lend, and invest capital. Without fair rule of law that clearly lays out such responsibilities, along with complaint and adjudication procedures to resolve contracting ambiguities, risk and uncertainty threaten exchange. An important aspect of the rule of law is its ability to limit and address failures in the marketplace that negatively affect the incentives of individuals to accumulate capital and the willingness of those who hold capital to lend and invest their capital. Much of the ability, or inability, to limit market failures falls in the realm of regulation that targets specific problems such as asymmetric information and transparency, cronyism and corruption, fraud, and adjudication of disputes. Good regulatory arenas help constrain such threats to effective market exchange but are not so onerous as to impose excessive costs that discourage exchange, creativity, and risk taking.

Asymmetric information and poor transparency can negatively affect the incentives of holders of capital to engage in financial dealings and expose their capital if they think one party to an interaction knows something valuable that other parties do not, and if the rules of the game empower and enable that asymmetry. Severe enough problems of asymmetric

³Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), bk. 2, chap. 2.

information and transparency can lead to complete breakdown in the exchange of capital, a liquidity crunch. In a potential hegemon, this would undermine the ability of public and private actors to access the capital necessary to perform the collective functions described above.

Cronyism, corruption, and fraud can have similar consequences for the accumulation and exchange of capital. These affect perceptions of fairness, expectations about the rate of return on capital, and, consequently, the incentives to accumulate, lend, and invest capital. A political economy or capital market that is viewed as rigged or that benefits a particular group independent of economic capability will find huge obstacles to acquiring the critical mass of capital necessary to perform the collective functions discussed above or to develop the network of relationships required to manage economic and financial problems in the system. Those able to accumulate capital in such an arena will often hide their capital from those in positions of power through clever accounting or flight abroad. In effect, such arenas become self-limiting as they undermine the increasing returns characteristic of an effective capital market.

No system works perfectly, even those with the best intentions. Property rights can never be fully specified. Contracts specifying property rights and obligations in any exchange relationship are incomplete because of nontrivial transaction costs, problems of monitoring, and dilemmas of adjudication and policing. Successful capital market mechanisms mediate between savers and borrowers. Capital markets become large when they overcome barriers to anonymous exchange between lenders and borrowers. But this anonymity, the growth of transactional distance between lenders and borrowers, compounds potential dilemmas of monitoring, transparency, incomplete contracts, and disputed property rights. Successful political economies overcome such dilemmas when they develop adjudication mechanisms that settle disputes with perceived consistency and fairness. For capital market arrangements to move successfully beyond national boundaries in terms of transactional geography, such adjudication mechanisms must be viewed as attempting to treat all parties fairly, evenly, and without national bias. Foreign lenders and borrowers of capital must perceive that the adjudication process, the rule of law, applies equitably for nationals and foreigners. Outcomes in the adjudication process must be viewed as relatively independent of nationality; otherwise, national bias is simply a version of cronyism, with similar consequences for the accumulation and redistribution of capital.

Taxation

Taxation is another key public arrangement affecting the capacity of a society to provide the collective functions that underpin liberal hegemonic leadership. Taxation draws on the resources of society through public extraction and redistribution of society's wealth. Few relish paying taxes, but taxation is essential to modern society. Oliver Wendell Holmes reportedly called taxes "the price we pay for a civilized society." There are good and poor tax systems. Good systems enable governments to develop reliable sources of capital and allow them to anticipate revenues from year to year and to budget those revenues. Reliability protects against

volatility in government revenues that limits long-term planning, which is important for investment in the scaffolding that supports productive social and economic activity over time.

Good tax systems are perceived as relatively fair. This means that all classes and groups in society are taxed to contribute to societal outcomes. In fair systems no group systematically evades the burden or responsibility of taxation. For example, in the Spanish Habsburg Empire, members of royalty were exempted from taxes. At the time that the Dutch revolted from the Habsburg Empire in the mid-1500s, the Spanish monarchy, a military superpower of the time, could not draw upon the wealthiest segment of the society to help pay for the conflict. Meanwhile, the rebel Dutch did tax across a broad swath of society to help pay for their rebellion. The Spanish system was relatively unfair, placing disproportionate burdens on particular segments of society, whereas the Dutch used a fairer system that spread the burden. Perceptions of fairness affect incentives to evade and to pay taxes. Fair systems, those distributed across all classes and groups (with notable exceptions, such as religious institutions and orders), tend to encounter less opposition and tax avoidance. The transaction costs of collecting taxes are also lower in fair systems. This leads to greater efficiency and more revenues, as more members of society contribute and with less extraction and monitoring costs. Fairness is positively related to legitimacy and stakeholding in a society, but it is also instrumental in helping with reliability and predictability of revenues and, consequently, planning and investment for the future.

Taxation also contributes to a government's ability to borrow from private holders of capital. Reliable and fair tax mechanisms produce dependable revenue streams, which signal prospective purchasers of government debt about the government's ability to service that debt and meet its obligations over time. Effective taxation contributes to the ability to incur public debt by providing credible mechanisms to finance that debt over time. Connecting a stream of revenue such as taxes to a financial obligation enables a government to borrow more and at lower costs. A reliable and fair tax system effectively serves as a form of collateral to secure debt. Linking a fair and reliable tax system with the ability to borrow capital is a central ingredient of a hegemon's capacity to provide liquidity and act as lender of last resort for the system.

Public Debt

An effective public debt market is a necessary condition for any modern state, especially one that attempts to act as the system stabilizer and provide the collective functions discussed earlier. How is the ability to issue government bonds and run a public debt an important contributor to stable governance and, in the special case of the system leader, hegemonic capacity? Many assert that debt is a problem, not a "blessing" as asserted by Hamilton in his *Report on Public Credit*. All societies encounter emergencies with financial demands that fall outside the boundaries of normal taxation and planned budgets based on anticipated revenues. Even the most successful and stable political economies face unexpected emergencies that defy foresight and overwhelm funds set aside for such crises. Wars, earthquakes, epidemics, climatic disasters, economic crises, and other emergencies can easily produce demands on governments that exceed

their revenues. Delaying responses to such emergencies until taxation raises sufficient capital could create social unrest and political instability that might threaten government survival.

Governments could wait until such emergencies take place to create **public debt** by introducing and selling instruments of government debt, but waiting for an emergency to create a market for public debt has pitfalls that lead to increased costs and uncertainty for success. Without a history in public debt, a government does not have an opportunity to develop a reputation as a borrower. Is the government reliable, will it meet its debt obligations, or will it renege? Without a history of borrowing, or with a poor reputation, governments are compelled to pay higher risk premiums on loans needed to address emergencies or budget shortfalls that exceed government revenues from taxation. This can be very expensive capital, which may create future dilemmas for a government as it attempts to service its debt and may even increase the incentives for policy makers in the future to renege on those obligations. Prospective lenders recognize such probabilities and may be reluctant to lend to a government without a history in public debt at a time of crisis, even with the additional risk premiums. Having an active public debt market provides prospective lenders with experience about the government as a borrower. A good reputation will reduce borrowing costs and increase the likelihood that a government trying to address unexpected crises will find the financing to do so.

Public debt is the debt owed by government. It is created when a government borrows to fund the difference between government receipts and government expenditures during a year. Governments borrow in public debt markets by issuing securities, bonds, and bills.

Public debt also acts as a constraint on a government's incentives to inflate money supply instead of raising taxes. Inflation is a hidden tax and a means to finance expenditures in the short run, but it detracts from the face value of notes in the public debt market. This reduces the incentives for investors to purchase or hold such notes, as they anticipate erosion in the value of their investment. This raises borrowing costs by increasing the risk premium—interest rates—to compensate for the risk of inflation. If inflation is severe enough, such incentives will fail to convince many investors to take such risks with their capital. An active public debt market can help constrain the incentives of politicians to inflate money supply instead of asking constituents to contribute more through taxation. A public debt market with low risk premiums reflects a political economy with developed financial mechanisms that can handle unanticipated emergencies and expenditures and can also balance the short-term temptations of policy makers to inflate money supply with their long-term interests of reasonable borrowing costs in the public debt market. Development of an efficient and reliable government debt market also helps in the development of private capital markets as individuals become acclimated to lending and investing through such instruments.

Lender of Last Resort

All modern political economies have some organization or organizations that perform the functions of a **lender of last resort** for their

A **lender of last resort** is a financial institution or government agency that acts countercyclically to ensure an adequate supply of capital during economic crisis, providing a collective good.

domestic political economies. These functions include, foremost, the management of money supply, but they can also involve regulation, bank supervision, provision of insurance or other backstopping for the banking system to protect against systemic risk, operation as a clearinghouse, and promotion of transparency in the banking system. Today, lenders of last resort typically take the form of public or quasi-public central banks, but in the past some private banks, or systems of private banks, performed such functions. The creation of a public central bank as lender of last resort rests primarily on the argument that private banking systems cannot be trusted to operate effectively in this role without strong external constraints or regulation. Competitive pressures among private banks can lead to destabilizing volatility and procyclical fluctuations, which can end in banking panics that spill over to produce severe economic dislocations in society. Proponents of a public central bank argue that a noncompetitive central bank, not devised to maximize profit and politically insulated, is often more capable of overcoming such volatility and acting countercyclically. Clearinghouse activities, monetary management, and bank supervision are more efficient if carried out by a single entity and are likely to be more transparent in the hands of a public entity than a private one.

Central banks are the primary tool by which modern states manage their money supply. Every public central bank is statutorily charged with at least one primary mission: price stability. Some public central banks are also tasked with another mission of equal weight: growth. With an objective of price stability, policy makers manage money supply to contain pressures that can inflate prices and undermine the value of capital assets held over time. Policy makers seeking to promote growth can increase money supply to lower the costs of capital as an input to production (supply-side stimulus) and increase the availability of capital to encourage greater consumption (demand-side stimulus).

Price stability and growth are often in tension with each other. From the objective of promoting growth, too much price stability limits the supply of capital available to purchase goods, expand production, and hire workers. This can produce damaging deflationary pressures that inhibit growth in a political economy. From the objective of price stability, monetary policy that is too liberal risks inflation that damages capital formation and currency stability. This creates the incentive to consume rather than to save or invest or to find a means of saving that bypasses capital instruments denominated in a currency experiencing

Price stability exists when prices remain relatively the same over time. In an economy, this means that it experiences neither inflation or deflation. Price stability is a function of money supply in an economy: too much produces price inflation; too little leads to price deflation. It is often in tension with the use of monetary policy to promote growth.

inflation. To avoid an inflationary currency, holders of capital may seek to move their capital abroad to purchase assets denominated in a more stable currency. They may seek to invest their capital in assets that hold their value over time even as the national currency depreciates, perhaps by storing value in durable goods whose prices will appreciate with inflation. If inflation damages the incentives for members of a society to save or invest in financial

instruments, then it comes full circle and undermines growth. Ironically, too great an increase in money supply to stimulate growth and employment can spill over to create an inflationary spiral that undermines asset values, causes stagnation, and leads to less growth and increased unemployment.

Managing the trade-offs between price stability and growth is a difficult balancing task for monetary policy makers. Many political economies try to circumvent the tension between price stability and growth by creating a statutory hierarchy in preferences over macroeconomic outcomes, generally with price stability dominating other objectives. Some political economies task their central banks with the responsibility only for maintaining price stability and limiting inflation. The defunct German Bundesbank and the current European Central Bank are examples of central banks focused on price stability above all else. The U.S. Federal Reserve and the Bank of England are examples of central banks that try to balance the dual objectives of growth and price stability.

A state that emerges as a liberal hegemon performs the lender-of-last-resort functions for the global arena. The hegemon's central bank and financial mechanisms effectively become the central bank for the broader system. A singular focus on price stability to protect against the ravages of inflation may be a sufficient objective for a lender of last resort in a national arena, but not at the global level. The lender for the global system must address the tasks of both price stability and growth. It must be willing to promote growth and risk inflation by manipulating money supply to inject liquidity and stimulate economic activity countercyclically and without hesitation at times of economic crises, systemic threats, and possible global contractions. A lender of last resort with a dominant preference for price stability over growth will be slow, if willing at all, to risk price inflation at home by creating sufficient liquidity to address a global economic crisis. Price stability to the exclusion of growth limits a society's ability to emerge at the hub of a network of global financial relations.

National Currency as an International Reserve Currency

Discussion of the lender of last resort for the global system leads to the final necessary, but still insufficient, aspect of public financial arrangements. A potential hegemon must be willing to expose its national currency to international use as a reserve currency, a means to settle cross-border transactions, and a storehouse of value. A potential system leader must be willing to have its currency become a transactional currency with a functional geography that extends beyond national boundaries. This requires a commitment to the open flow of capital and a rejection of capital controls as a policy alternative. Exposing a nation's currency to international use adds complications to the calculus for that nation's monetary policy makers, as it involves risks of losing some control over money supply and capital resources. The construction of hegemonic capacity derives partly from others' willingness to use the hegemon's currency to settle cross-border obligations and to hold as a reserve asset. This is central to the creation of networks that place a

political economy at the hub of the relationships that are essential to managing international economic and financial shocks. A national lender of last resort with a primary focus on domestic price stability may be less willing to expose its currency to such a role—to create sufficient liquidity in its currency to enable its use as a reserve asset, a means of settling accounts, and a tool to promote growth in the system. A national lender of last resort with a primary focus on domestic price stability would worry that creation of such liquidity for international uses—to lubricate the international economic system—could threaten domestic price stability if brought home. Yet this willingness to expose one's currency internationally, to risk price inflation to promote growth and manage international distortions, sits at the heart of the reach of a potential hegemon's monetary policies by leading to the construction of a network of relations that are key to managing systemic economic and financial crises.

PRIVATE FINANCE AND THE HEGEMONIC PROVISION OF COLLECTIVE GOODS

Private as well as public financial arrangements contribute to the emergence of large and effective capital markets that encourage capital accumulation, formation, application, and perhaps even hegemonic capacity if such markets emerge at the hub of a network of global financial relationships that provide a society with an ability to promote growth during good times and manage systemic crises during downturns. Below, we focus on a handful of important nongovernmental characteristics: capital market size, market diversification, market depth and liquidity, market transparency and clearinghouse mechanisms, and the absence of informal barriers to cross-border participation.

Capital Market Size

Capital markets are those financial markets where enterprises and governments issue and trade financial obligations with maturities longer than a year.

Surpassing some threshold of **capital market size** is almost self-evident as a necessary qualification for attaining hegemonic capacity. The collective functions discussed earlier are primarily financing mechanisms to inject liquidity that encourages investment and growth and finances consumption and exchange, both pro- and countercyclically. Doing so productively for a single national political economy requires some relatively efficient means of transferring resources from those with capital surpluses to those short of capital in order to finance their activities. The demands on private and public mechanisms to perform such functions adequately for a single political economy are substantial. Many societies fall short of meeting such needs. Demands grow exponentially for a political economy that can perform these collective functions for the global system. A political economy with the ability to exercise leadership must have access to extraordinary sources of capital and be able to influence the use of that capital to inject liquidity into the system during economic good

times and hard times. Large capital markets, by their size, are testaments to their ability to attract both savers and borrowers.

Capital Market Diversification

Capital markets in successful political economies take a variety of forms—banking systems, securitization of debt in bond markets, equity markets, money markets, futures and derivatives markets, currency markets, venture capital markets, and others. Many political economies rely heavily on one form or another. A potential hegemon must have a diversified portfolio of capital market mechanisms. Diversity enables holders of capital to find different levels of risk, to match their risk tolerance with instruments across different markets, and to alter their exposure during times of crisis. Multiple forms encourage competition in the private marketplace for capital. Competition leads to innovation, which can produce greater efficiency in the accumulation and redistribution of capital resources. These characteristics of diversity contribute to the attractiveness of a political economy's private capital markets and can induce an increasing return dynamic that expands the pool of accessible capital and enhances a political economy's capacity to provide liquidity during good and bad times.

Capital Market Depth and Liquidity

Such capital markets must also be deep and liquid, characteristics that are endogenous to their size and success. Depth and liquidity help investors manage the risk to their capital over time and make such markets attractive. In deep markets—that is, markets with vast amounts of assets—even large transactions usually leave asset prices relatively stable. Deep markets help limit investor risk from volatility and large unexpected shifts in asset prices, and so are relatively more orderly than less deep markets. In liquid markets, investors can easily move their assets in or out of investments—an immediate market exists for transactions, with little to no lag in the conclusion of purchases or sales of assets. Liquid markets reduce risks by protecting investors from the dilemma of holding assets they do not want but cannot trade quickly.

Depth and liquidity make for more orderly markets. They limit risks from volatility and from the dilemma of holding assets investors may not want. These qualities help attract domestic and international capital. International capital is integral to the accumulation of sufficient capital resources and the creation of the cross-border networks that are essential to hegemonic capacity and to managing systemic economic dislocations. As more international capital flows into such markets, they move beyond being just national capital markets that bring together domestic savers and borrowers. The flow of international capital into these markets increases global financial integration, linking investors and borrowers of different nationalities and financing economic activities far beyond the national boundaries of such markets. This creates a global financial nervous system that links economic activity, private economic actors, public policy makers, and regulators across borders.

Market Transparency and Clearinghouse Mechanisms

Transparency and clearinghouse mechanisms are integral to these large markets. Transparency means that trades, positions, associations, and other activities that can influence prices are readily apparent and available to most, if not all, informed participants engaged in exchange. The admonition “Let the buyer beware” rests on an assumption about the ready availability of relatively complete information and transparency. Public regulatory activities such as legally mandated and monitored disclosure and reporting requirements affect transparency, but so do many activities in the private sphere. All good-size financial markets involve private organizations that serve as clearinghouses that transfer property rights quickly and unambiguously. With a good clearing mechanism, records of market activity are readily accessible to those completing exchanges and those contemplating exchanges. Good private market organizations publicly report trading activity relatively quickly after the completion of trades. Transparency, clarity, and efficient completion of exchange limit threats to market activity from asymmetric information, incomplete property rights, time, insider trading, cronyism and corruption, and unfair manipulation. They help enhance confidence that a market is fair and trading is legitimate.

Openness and Absence of National Bias

For a political economy and its capital markets to emerge at the hub of a network of global financial relations, the state’s borders must be relatively porous to the international flow of capital. This requires willingness on the part of the political economy to allow its currency to become an international transactional currency, to allow its currency to move beyond the limits of national geography, and to reject capital controls. These are public policy choices made in the public arena, but private activities can also influence international access to a political economy’s capital markets. Social arrangements and business practices can work, intentionally or not, to discriminate against nonnational investors and borrowers. Informal practices can discriminate by creating pathways that advantage national participants over international participants. Such practices create barriers to entry and an insider-trading advantage for those in the club versus those outside. Strong national bias generally works by undermining transparency and obscuring the informal rules of the game to outsiders while providing informational and bargaining advantages to insiders. In effect, this places outsiders at a competitive disadvantage. This is a form of market failure created by national geography.

Such national bias limits the attractiveness of markets to international investors and borrowers. This constrains the construction of cross-border financial networks, which are essential to creating the capacity to exercise leadership and to address systemic problems. A relative absence of national bias in business and social practices and a willingness to ignore nationality as a basis for business dealings are essential for a political economy to develop global capital markets that are welcoming to both national and international participants. Some national bias is inevitable, but a global market is marked by a relative absence of such bias compared with national markets, which are more inward looking.

CHANGE AND DEVELOPMENT OF HEGEMONIC CAPACITY IN A GLOBAL FINANCIAL NETWORK

How does a political economy develop such capacities? Developing the sound governance and financial capacities that sit at the heart of a sophisticated global financial network and underpin hegemonic capacity is far easier said than done. Political economies are not naturally imbued with such abilities. Developing them demands a significant change in the status quo that has characterized all societies at one time in their pasts. Historically, political authority has generally emerged to advance and protect the narrow interests of a relatively small, privileged group, who often prey on the rest of the groups in their societies. Such elites seek to consolidate and advance their position in society, even to the neglect or detriment of the broader society. They protect their position of economic and political power, advancing policies that improve the welfare of their broader societies and enhance their place on the global stage only if those policies also reinforce or improve the elites' narrowly privileged position. Consequently, at the origins of every form of political authority—nation-states, fiefdoms, city-states, feudal kingdoms, tribes, and other forms of political economic organizations—the financial status quo is dominated by arrangements that favor privileged elites, encourage cronyism, lack transparency, support arbitrariness and corruption, obscure financial obligations, and distort legal recourse to those claims. The economic and financial practices that evolve in nascent and emerging systems reflect asymmetries in power and interests. The foundations of modern, productive, and socially efficient governance and finance are nonexistent in such systems.

Moreover, the status quo is highly resistant to socially productive change because it threatens the privileged and powerful. These socially perverse forms of political economic organization are generally self-reinforcing absent some dramatic change. Practices in such systems are resistant to change, much to the frustration of those engaged in fostering development. Those in privileged positions in society employ the tools of government, force, corruption, family connections, and cronyism to hold on to their positions. They resist shifts that could threaten their privileged position and often seek to limit the competition that contributes to political, economic, and social mobility in a society.

If such systems are robust, how can a socially vicious status quo or equilibrium be disrupted to generate reforms that transform public and private financial arrangements into those that are more socially productive? Significant crises or shocks such as war, severe economic downturn, or revolution play a critical role in transformation. They create opportunities to discredit and disrupt a socially dysfunctional status quo that rewards insiders, cronies, and elites at the expense of the broader society and economic efficiency. A shock that challenges the foundations of political authority, social structure, and economic organization provides an opportunity to alter the status quo. This can produce changes in governance and the financial rules of the game. Some changes can be productive, opening up avenues for new economic actors to achieve success and producing more efficient outcomes, economically, socially, and politically. These alter economic and social

relations for the better in the long term, even transforming a political economy's position in the global arena.

However, productive change is not always a consequence when severe shock and crisis challenge the status quo. Many policy makers, political economies, and societies respond poorly when confronted by serious challenges. Governments often learn the wrong lessons and respond poorly to shocks. Many policy makers, when confronted by crises, stick with the status quo and create barriers to change in the social, political, and economic order; some adopt changes that are more illusory than real; and others adopt changes that, while well-intentioned, fail to lead to real reform. Governments can limp along, sometimes as weak or partially failed states, without enacting reforms that help address the ills of their societies.

Even in the best cases of well-intentioned reformers, a great deal of what some call luck operates in the evolution of hegemonic capacity. Rationally designed reforms following a shock can be well-intentioned yet still fail or produce unintended outcomes, given the difficulty of fully anticipating how reforms will actually operate in a world of interdependent choices. For societies that reform their governance and financial arrangements in response to dramatic shocks, the potential for such reforms to create the capacity for leadership in the global arena is determined by whether the new rules of the game develop credibility, how people respond to those reforms over time, whether a critical mass of economic actors respond positively, and whether the actions of those economic actors create a global network of financial relationships.

Credibility of Public and Private Financial Arrangements in the Global Political Economy

If a sufficiently large political economy adopts and implements effective governance and financial reforms following a shock, there is no assurance of its emergence as a global financial center or its ascendance to liberal economic leadership. The reforms must first come to be viewed as credible commitments to fair, transparent, and legally protected capital formation, accumulation, and exchange. To develop the necessary credibility, new regulatory arrangements and rules of the game must be tested. Following a crisis that challenges the status quo and promotes changes in the rules of the game, economic actors and private holders of surplus capital approach new arrangements with some trepidation. They are unsure of how the new arrangements will operate and whether they will work. They are suspicious of commitments to reforms by public and private authorities that were more often than not involved in the failed practices of the past. Perhaps the reforms are merely cheap talk—illusory shifts lacking real substance. Should economic actors trust the reforms and put their capital stocks at risk? Are the reforms credible? And, even if they have been sincere in their intentions in adopting the reforms, do public and private authorities have the capacity to implement the new rules of the game?

One significant obstacle to such reforms quickly obtaining credibility is that those adopting reforms control the levers of power. The very source of their capacity to change the rules of the game and adopt reforms is also a source of their capacity to renege on those changes

should they decide to. No third party or overarching authority exists in the nation-state system to sanction governments that arbitrarily ignore the rules of the game they have constructed to guide relations within their national boundaries. For their commitments to be credible, governments, by their position in the domestic hierarchy, must exercise self-restraint. History is rife with examples of governments renegeing on their commitments—defaulting on their debts, suspending constitutions, being selective in the enforcement of laws, and other rejections of the statutory rules of the game. There is no magic strategy in institutional design that immediately graces reforms in such contexts with credibility.

Holders of capital who have recently experienced severe trauma to their societies and portfolios are likely to be risk averse and to protect their assets even if reforms purportedly embrace transparency, mechanisms that promote fairness (such as oversight and adjudication of complaints), and other countervailing mechanisms that appear to limit arbitrary actions by those in positions of authority. During and following an economic or financial crisis, such risk-averse, conservative responses limit the exchange of capital between those with surplus capital and those in need of capital for their economic endeavors. Usually, economic actors adopt a wait-and-see strategy to evaluate the sincerity and efficacy of reforms, rather than take reforms at face value. They wait and see how the system performs at times of normalcy and stress. Time and testing provide holders of capital with information about the credibility and efficacy of reforms following severe shocks. If good reforms become credible, then the financial capabilities and complexity of the political economy will expand.

Increasing Returns and Network Externalities Necessary to Become a Global Capital Financial Center

Good and sincere reforms and rules of the game do not ensure that a large political economy and its financial arrangements will become a significant, even hegemonic, player in the global arena. Many well-regulated and effective financial arenas in large political economies remain local or regional markets with limited capacity and reach. Many well-run, stable, and fiscally reliable governments with good mechanisms of public finance exercise only limited reach and influence outside their national boundaries. Successful global capital markets enjoy a disproportionately increasing return dynamic that attracts more and more capital, which produces an increasingly dense network of relationships that become self-reinforcing and increasingly influential over the choices of others.

Successful capital markets enhance transparency, reduce transaction costs, offer strategies to hedge and manage risks, stabilize expectations, reduce volatility, and generate long-term stability that affects rates of return and predictability. Such markets tend to attract capital, more capital, and then more capital. This creates deep and liquid markets. The bulk of internationally mobile capital likes such qualities and searches out such markets, particularly at times of increased risk and uncertainty. In the case of a market that emerges as a global market, this market has outdistanced most others in terms of size, liquidity, depth, and attractiveness to new capital. The more capital it attracts, the more other capital finds it attractive.

As a market grows larger, moving from local to regional and perhaps to global, it becomes more densely connected through networks of complex relationships that span national boundaries. During times of global economic expansion, savers and borrowers become connected across national borders through such markets. Capital access improves and capital costs decline within such networks. A deep, liquid market that is connected across national boundaries generates network externalities that are mutually reinforcing. It also creates a web of relationships that often generate mutual, coherent, and consistent incentives across public and private spheres. These can be mobilized to help manage economic or financial shocks that threaten the system. At the hub of this global financial network are the hegemon's capital markets, its regulators, and its policy makers. As the source of financial collective goods to the system, public and private decision makers in other countries are attentive to suggestions and actions originating in the hegemon's public and private financial institutions. Having private capital markets at the center of global financial and economic relations is a necessary condition for liberal hegemony, but it is not sufficient, given the reluctance of private actors to engage in countercyclical efforts during a severe downturn. During bad times a public actor—a government acting as lender of last resort and assembling consortia of capital to rescue a system in crisis—must be both willing to manage and manipulate the network created during good times and capable of doing so.

Hegemonic influence is a form of soft power embedded in the structure of relationships that emerge as a consequence of governance and public and private financial arrangements—a global nervous system centered on the dominant political economy. It is easier to cooperate and play within the rules of the game supported by a liberal hegemon during good times. Most everyone likes the financier and tolerates its regulators during expansionary times, when capital is plentiful and affordable. The global financial nervous system that connects political economies is often underappreciated during good times. Yet this same system transmits economic dislocations across borders, which can raise doubts about the rules of the game. The network that transmits economic dislocations across national boundaries also provides channels along which a liberal hegemon can exert influence by providing collective goods and liquidity that encourage international cooperation, limit the emergence of dislocations, and, ideally, contain dislocations when they do occur—to stabilize rather than destabilize.

ALTERNATIVE EXPLANATIONS OF THE SOURCE OF HEGEMONIC LEADERSHIP

Let's quickly consider and discount two important competing explanations for the source of hegemonic leadership: size and the establishment of stable and productive property rights. The latter is often subsumed under the category of rule of law. One commonly advanced argument is that the largest state acts as the hegemon. Many use economic, military, or demographic size as a proxy for the processes that spawn the capacity for global leadership, but without explicitly examining the domestic foundations of this leadership. From this

perspective, some measures of dominance might include GNP or GDP, output per capita, indices of industrialization, shipping tonnage, and military size.

Another explanation is that stable, well-established rule of law and property rights underpin successful political and economic development and, consequently, also hegemonic capacity. Good rule of law and property rights are relatively important, as no political economy will grow efficiently beyond small-scale economic exchange without such institutions. Without doubt, successful political economies require well-established rule of law and property rights that reduce uncertainty, stabilize expectations, lower transaction costs, increase transparency, improve contracting, and provide incentives for self-interested individuals to engage in individually and socially productive exchange. A commercial and financial hegemon will have such rule of law and property rights, for they are essential to its economic growth and success. Predictable, well-established property rights are necessary components of a hegemon's makeup but are not sufficient conditions to create the capacity for hegemonic leadership. Many societies develop productive property rights. The modern industrialized world is full of examples of political economies with property rights that contribute to good economic and social outcomes for those societies.

History enables us to recognize quickly that these two popular explanations for hegemonic capacity—size and rule of law—are incomplete and insufficient. History shows that size is relatively important, but a hegemonic state might not necessarily be the largest state—economically, demographically, or physically. Size alone is not sufficient to give a state the capacity to perform these functions. History also demonstrates that all the hegemonic states of the modern state system—the Dutch Netherlands from 1500 to 1700, the United Kingdom from 1700 to 1900, and the United States since the mid-1900s—enjoyed good property rights, but they were not alone in doing so in their eras.

In the case of the United States in the twentieth century, both size and rule of law look like plausible explanations for U.S. hegemonic capacity. Yet size alone cannot account for the absence of U.S. leadership during the interwar years, the emergence of Dutch commercial and financial hegemony in the 1600s, or British leadership from 1700 until 1900 in the face of a French economy that was far larger and more populous. As a predictor, size would be wrong in two of the three cases of liberal hegemonic leadership since 1600.

In 1566, seventeen provinces rebelled against the control of the Spanish Habsburg Empire—the most powerful military empire in Europe. The Dutch provinces had adopted rules to protect the foundations of commerce and economic exchange. Contracts were respected and enforced, debt obligations met, taxes raised, and the practices of commerce honored. This enhanced the ability of the Dutch to raise capital during times of crisis. With only about 1.5 to 2 million inhabitants, the seven northern provinces (the Dutch United Provinces) resisted Habsburg Spain's attempts to reassert control, successfully staving off the world's most powerful military and an empire far more populous. During the conflict, the Dutch established a governance and financial framework that contributed to their emergence as a commercial and financial hegemon.

Within a short time, Dutch ships carried more freight in the Baltic than did the Hanseatic League, the Germans, or the Danes; more tonnage in the North Sea and along the north European coast than did British, French, or Spanish vessels; and more goods in the Mediterranean than did Portuguese, Spanish, or Italian ships. Dutch shipping came to dominate trade in herring, salt, lumber, spices, and textiles. Amsterdam surpassed Antwerp of the Spanish Netherlands to become the dominant market hub of overland trading routes as well as sea trade. The Dutch guilder became the preferred currency for pricing and settling international transactions. The Bank of Amsterdam and Dutch financial markets became the central clearinghouse for international finance. Remarkably, by the early to mid-1600s, the Dutch became the first global liberal entrepôt after enduring political and economic conflicts with the Spanish, British, and French and despite their relatively small demographic and geographic size. The commercial hegemony of the Dutch Netherlands lasted for about a century, its financial hegemony almost two centuries, before being eclipsed by the British. Dutch power and influence over the rules of the international game far exceeded what might have been expected given the nation's size; the Dutch Netherlands was dwarfed demographically, militarily, and economically by several major European powers. The Spanish Habsburg Empire, France, and the United Kingdom were far larger political economies with much larger populations.

The British case is another example in which size alone is an insufficient explanation for hegemonic leadership. Following the invasion of England by Dutch forces led by William of Orange in 1688 and the changes wrought in British political and economic life by the Glorious Revolution, the United Kingdom would eventually surpass the Dutch Netherlands as the commercial and financial hegemon in the global arena. The Dutch invasion of England and the Glorious Revolution in 1688 brought important changes in the relationships among the Crown, Parliament, and society. William and Mary's conquest infected English governance and state-society relations with many of the same characteristics and institutions that helped the Dutch rise to commercial and financial hegemony. Changes in the relationship between the Crown and Parliament constrained the Crown from renegeing on its financial obligations, changed the rules of borrowing for the government, altered the nature of property rights in society, and spurred financial market development. These changes improved the efficiency and attractiveness of London's capital markets. These markets stimulated English growth, funded English overseas expansion, financed more than a century of sporadic warfare with France, led to London's rise as the center of global finance, and made the British pound the dominant currency for pricing international transactions and settling international accounts.

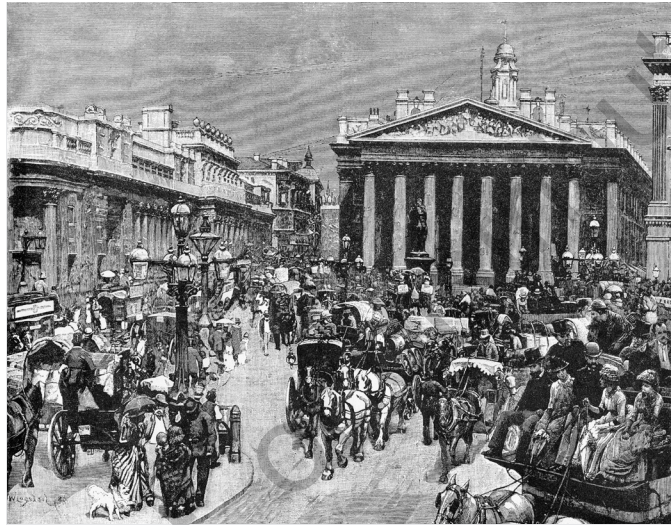
London, with its capital markets and merchant bankers, would soon pass Amsterdam as the center of global finance. Sovereign bond issuances in London financed state consolidation, government development, infrastructure projects, and public and private activities in many countries. H.M. Treasury, the Bank of England, London's capital markets, and English merchant bankers would soon sit at the hub of commercial and financial relations in the global economy. The position of London's capital markets and the appeal of exporting goods to British markets provided British policy makers and private financiers with tools to promote

a liberal global economy and manage economic crises—to establish and maintain the rules of the global economy.

In regard to the variable of size, this might not seem unusual, for England had always been a larger political economy than the Dutch Netherlands. But how does size explain England and not France becoming the hegemonic state? British hegemony emerged in the face of the far larger, more populous economy of France. During the 1700s and early 1800s, France competed politically, militarily, and economically with England for global influence. Centrally placed on the Continent, France dwarfed England in terms of physical and demographic size.

Before the Industrial Revolution, France enjoyed a larger economy in absolute terms. Nevertheless, England—with a population far smaller, with fewer gold reserves, and with less territory—emerged as the commercial and financial hegemon, setting and maintaining the rules of the game in the global economy. Only after the British economy embarked on the Industrial Revolution did British output and economic prowess actually exceed those of other nations, but only for a short time, because the United States and Germany, which industrialized later than the United Kingdom, both passed the British by the late 1800s. By 1900 the United States had become the largest economy, yet the United Kingdom remained the commercial and financial hegemon of the system until World War I. Size above some threshold may be a necessary but not sufficient condition for setting the rules of the game for the global political economy.

U.S. leadership following World War II is the sole case where sheer economic size and the hypothesized essential financial institutional arrangements overlap. It is the confounding of these factors that makes the Dutch and British cases so important for gaining understanding of the relationship between domestic financial arrangements and hegemonic leadership. U.S. leadership was overdetermined, as the United States had by far the largest economy in the world at the end of World War II and the financial capacity and institutions essential to stimulating and stabilizing the global economy. U.S. economic size and capacity as a share of the global economy were unparalleled.



As London became the center of global finance, British policy makers gained tremendous tools to help manage the global economy, promote cooperation, and address dislocations that could threaten globalization. At the heart of this capacity sat the Bank of England, H.M. Treasury, London banks, and British capital markets. Pictured here are the Bank of England and the Royal Exchange.

Even before the end of World War II the United States demonstrated its ascension to the role of commercial and financial hegemon by hosting and guiding the Bretton Woods negotiations. These led to international agreements and a postwar framework of international governmental organizations that supported U.S. efforts to promote the globalization of market relations. During the latter half of the twentieth century, U.S. policy makers worked with these IGOs, as well as U.S. capital markets and private financiers, to manage economic and financial dilemmas that threatened global economic stability and market exchange.

CONCLUSION

History provides important evidence that the rule of law and property rights should be discounted as necessary and sufficient conditions to account for liberal hegemonic capacity. Without doubt, successful political economies require well-established rule of law and property rights that reduce uncertainty, stabilize expectations, lower transaction costs, increase transparency, improve contracting, constrain socially destructive predatory behavior by elites, and provide incentives for self-interested individuals to engage in individually and socially productive exchange. A commercial and financial hegemon has such rule of law and property rights. Yet, even though they are necessary conditions for commercial and financial leadership in the global arena, they are not sufficient conditions. Many societies develop productive property rights and good rule of law. The modern industrialized world is full of examples of political economies with property rights and good rule of law that contribute to productive economic and social outcomes for those societies. The Dutch, the British, and the Americans all enjoyed such conditions, but they were not alone in their eras—although examples of good property rights and good rule of law were far scarcer in the 1500s than in the 1900s. Many states with good rule of law and property rights did not develop the capacity to establish the rules of the global game and sit at the center of global economic activity.

Some level of size and good rule of law and property rights are necessary conditions, but, by themselves or even together, they are insufficient to account for a state emerging as a liberal commercial and financial hegemon. Many nations are sufficiently large but do not acquire the capacity for liberal hegemony. Many nations develop sound rule of law and property rights and yet fail to develop an ability to provide important collective goods to support international cooperation during good times and bad. Some nations may be large enough and enjoy the necessary institutions, yet fall short of being able to act as a liberal hegemon despite a desire to assume such a role.

At the core of hegemonic capacity and leadership sit important mechanisms of public governance, public finance, and private finance. These mechanisms are essential to the emergence of a financial center in a political economy that is really a global financial center. This places that political economy at the heart of a global network and provides it with the tools to promote economic expansion not just at home but globally as well. It also creates the capacity and tools to help manage and limit economic downturns that could damage

international relations, undermine the cooperation essential to productive globalization, and produce destructive policies that fuel rather than limit such downturns.

Important Caveat

This chapter focuses on the role of public and private financial arrangements in underpinning the capacity to exercise critical leadership in a capitalist global political economy. I do not want to leave an impression that other factors are unimportant. This should be apparent from the section on alternative explanations, which considers the roles of size, rule of law, and property rights. These are important and necessary conditions but not sufficient conditions for a political economy to develop the ability to exercise liberal hegemonic leadership. In addition, one could easily isolate other contributors to a political economy's position in the global hierarchy and the capacity to exercise leadership. One could point to the importance of entrepreneurial spirit in unleashing creative processes and elevating a political economy in the hierarchy; the quality of educational infrastructure, which transforms human capital; the role of openness to immigration in infusing a political economy's labor pool with new and hungry members; or the ease of starting a new business. These all influence outcomes in a political economy and its trajectory in the global hierarchy. But in the end, these work only if national security sectors, entrepreneurs, immigrants, and start-ups can find access to capital efficiently and reliably. Everything takes us back to the centrality of financial mechanisms to modern political economies and to the global economy.

KEY CONCEPTS

capital markets (p. 238)	hegemony (p. 223)	price stability (p. 236)
hegemonic stability theory (HST) (p. 223)	lender of last resort (p. 235)	public debt (p. 235)
	liberal hegemon (p. 223)	

EXERCISES

1. What are the collective goods that a liberal hegemonic state provides?
2. What is at the essence of such collective goods?
3. How does a hegemonic leader overcome the collective action problem discussed in chapter 5?
4. What states have provided hegemonic leadership during the era of the modern Westphalian state system?
5. Why is liberal hegemonic leadership important for globalization and international cooperation?

6. Absent liberal hegemonic leadership, why might cooperation break down in the international system and damage globalization?
7. What does a lender of last resort do?
8. What is the tension between growth and stability that lenders of last resort often encounter in their policy deliberations?
9. How do the networks develop by which public and private policy makers in a liberal hegemonic state exercise their influence globally?
10. In recent times, critics have questioned the size of many governments' public debt obligations. Despite the question of size, why are public debt markets important in terms of social welfare?
11. Political scientists tend to focus on public governance, but the private sphere is also a critical component of hegemonic capacity. Explain.

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