DEMOCRATIC ORIGINS OF 2007–2009 FINANCIAL CRISIS IN THE US: AN INSTITUTIONALIST ANALYSIS

by

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STATEMENT OF AUTHORSHIP

This thesis contains no material which has been accepted for any award or any other degree or diploma in any University or other institution. It is affirmed by the candidate that, to the best of his knowledge, the thesis contains no material previously published or written by another person, except where due references is made in the text of the thesis.

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ABSTRACT

In the mid-2007, a liquidity crisis and credit crunch emerged in the United States (US) financial markets due to a dramatic fall in housing prices and defaults in sub-prime mortgage payments. The prior analyses discussed the systemic weaknesses of the financial system, right economic measures to prevent deepening of the crisis and the limits of international cooperation. This thesis, however, focuses on the political origins of the 2007-2009 financial crisis in the US context, particularly discussing how financial architecture that is prone to crises emerged in a democratic setting in the last three decades. The analysis is based on the observation of the historical and empirical evidence indicating a puzzling relationship: Legal and institutional changes embodied the new financial architecture through a set of decisions in democratic processes. At the same time, these changes in the financial realm weakened middle and lower class Americans with stagnant real wages and income inequality. On this basis, this thesis questions how it was politically feasible to institutionalize such a financial system in a democracy with observable negative impacts on the larger of segments of American society. Utilizing institutional analysis and examining the dynamics of American politics, this thesis argues that the new financial system provided cheap and largely available credit options for the broader segments of society to compensate stagnant wages and income inequality. Middle and lower class Americans preferred short-term satisfaction of needs through extreme borrowing provided by the new financial innovation and deregulation. In other words, the broader segments of middle and lower class Americans consented on the institutionalization of new financial system in return for preserving historically constructed living standards.

Key words: Institutionalism, New Financial Architecture, Income Inequality, Political Behavior, the United States

ÖZET

2007 yılı ortasında Amerika Birleşik Devletleri (ABD) finansal piyasalarında, konut fiyatlarındaki ani düşüş ve tutsat geri ödemelerindeki aksaklıklardan kaynaklanan likidite ve kredi daralması krizi yaşandı. Bu konuda yapılan ilk analizler finansal sistemin yapısal sorunlarına, krizin derinleşmesini önleyecek ekonomik önlemelere ve uluslar arası işbirliğinin sınırlarına dikkat çektiler. Bu tez ise 2007–2009 finansal krizinin siyasal Amerika bağlamında siyasal nedenlerine odaklanarak, kriz yaratan finansal sistemin son 30 yılda demokratik bir yapı içerisinde nasıl ortaya çıktığını irdeliyor. Tarihsel ve ampirik kanıtlar buradaki analizin temelini oluşturmakla birlikte paradoksal bir ilişkiyi de gözler önüne seriyor: Yeni finansal yapıyı inşa eden yasal ve kurumsal değişiklikler demokratik süreçlerin sonunda ortaya çıkıyor. Aynı zamanda finans alanındaki bu değişiklikler Amerika'daki orta ve alt sınıfların zayıflamasına yol açtığı gibi reel ücretlerin durağanlaşmasına ve ekonomik eşitsizliğe katkıda bulunuyor. Buradan hareketle bu yüksek lisans tezi, Amerikan halkının büyük bir kesiminin zarar görürken, yeni finansal yapının demokratik sistem içerisinde nasıl kurumsallaşmasının mümkün olduğunu sorguluyor. Kurumsal analizi kullanarak ve Amerikan siyasetinin dinamiklerini de dikkate alarak bu tez çalışması, yeni finansal sistemin sağladığı ucuz ve yaygın kredi olanaklarının halkın geniş kesiminin yaşadığı durağan maaşlar ve gelir eşitsizliğini dengelediğini ortaya koyuyor. Buna göre, orta ve dar gelirli Amerikalılar finansal serbestleşme ve yeniliklerin katkısıyla aşırı borçlanarak kısa vadede ihtiyaçlarının temini yolunu seçtiler. Bir başka deyişle, tarihsel olarak belirlenmiş yaşam standartlarını korumak adına, Amerikan orta ve alt sınıfları, yeni finansal sistemin kurumsallaşmasına rıza gösterdiler.

Anahtar kelimeler: Kurumsalcılık, Yeni Finansal Yapı, Gelir Adaletsizliği, Siyasal Davranış, Amerika Birleşik Devletler

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INTRODUCTION

In the mid-2007, a contagious liquidity crisis and credit crunch hit the world markets, dramatically affecting the financial institutions in the US and spreading into European and Asian markets. The crisis started with the bursting of US housing bubble and the sub-prime mortgage crisis. In order to prevent the credit crunch, the central banks of major developed countries prompted unprecedented emergency measures and injected more than $240 billion into the markets in mid-August (Nesvetaliova, 2008, p. 3). Nonetheless, the balance accounts of major financial institutions continued to deteriorate in throughout 2007 and 2008. For instance, the Northern Rock -one of the major British banks involved in mortgage related credits- sought and received liquidity support from the Bank of England on September 14, 2007 and finally taken into state ownership in February 2008. Indeed, none of the economic analysts and financial actors was able to clearly estimate the scope of the problem in the financial system. Previous commentaries and studies rather focused on the dynamics of the perverse incentives in the system and the existence of toxic funds stemmed from the financial derivatives.

Failure of financial institutions and the realization of the scope, dimension and severity of the crisis also led to a major decline in stock prices and commodities. Uncertainty and volatility in the stock market further weakened the financial institutions –with severe decline in their stock prices and assets- and the early events were followed by the takeover of Bear Sterns in March 2008. Fannie Mae and Freddie Mac –quasi state owned mortgage credit institutions- ownership was also

taken over by the Federal Reserve (Fed). September-October 2008 witnessed the most severe bankruptcies and major losses in the financial markets. The Lehman Brothers –unlike the other financial institutions- was not provided Fed support and were allowed to bankrupt. To prevent the financial system to collapse, The Emergency Economic Stabilization Act of 2008 were passed with the revision of the Congress to the original plan of Treasury Secretary Henry Paulson, providing $700 billion liquidity to the financial system. The consecutive G-20 summits also did not have major positive impact on the pace of the crisis. By June 2009, all major advanced industrial economies entered into recession with serious decline in output, consumer confidence index, consumption, investment levels and exports. The IMF estimates indicate that the recession in the world economy will likely to continue in 2010 as well. Currently, there is a growing consensus that the current financial and economic crisis is the major economic shock in the postwar world economy.

The observers of the US economy stressed the systemic weaknesses of the financial system highlighting the inadequate regulation, high systemic risk via extreme leverage and the perverse incentives encouraging financial bubble in the housing market. Even though, most of these accounts were clear observations and analytic explanations of how financial crisis emerged in the US and contagiously spread into other economies, these earlier accounts were incomplete because they did not provide plausible answers to the political origins of the crisis in the domestic and international contexts. Rather, their concern was practical on the basis of dealing with the crisis with the right economic instruments or the possible contributions of international cooperation to increase coordinated action and to solve collective action

dilemmas. These were rather valuable efforts to understand and solve the current problems.

However, my intention in this thesis is different in the sense that I rather focus on the political causes of economic outcomes. Similar to these earlier accounts, I also discuss the systemic weaknesses of the financial system with reference to the evolution of international monetary orders, the deregulation of finance in the national contexts and the new dynamics of financial activities such as derivatives and leverage. Such an analysis is necessary to enlighten the causal mechanisms that created perverse incentives and encouraged the emergence of a financial system that is prone to crises. But my interest lies on the deeper roots of the current financial crisis. In other words, I am particularly interested to examine the political context that constituted the current financial system, which is volatile, uncertain and prone to crises. I focus on the US economy and question how new financial systems emerged within legal and institutional changes in a democratic setting. In short, the principal aim of this thesis is to explain the emergence of a new financial system in the US considering actors, interests and institutions within the broader dynamics of American politics.

Centrality of politics is the major hallmark of my thesis with the central argument that making of the recent financial crisis and the establishment of the current financial system cannot be confined to technical weaknesses and issues. For instance, the reason for the current crisis was not simply the dramatic fall in housing prices and the credit crunch occurred in the sub-prime mortgage market. The problem,

indeed, stemmed from the very nature of financial system that produced perverse incentives for financial firms and broader segments of society. In this manner, rather than the technical issues such as financial regulation, mortgage markets and leverages; I stress the political context that established a new financial order. Thus, I argue that the process of constituting a new financial order required strong political activity shaped and steered by certain powerful actors and their guiding interests. Hence, I examine how financial community was effective in mobilizing their resources in the Congress, throughout the political campaigns and in the state apparatus to deregulate finance removing the barriers in front of the new financial operations and instruments. For this reason, the major feature of the current study is to emphasize how economic and financial policies entail political choices and have distributional outcomes.

In this vein, I emphasize how actors, interests, power and ideas interact in the embodiment of policies and institutions. I reject the neo-classical economic tendency that identifies certain policies as 'right' economic measures to be necessarily followed by every government. Such a stance necessarily brings de-politicatization to the policy-making process and over-represents business and financial interests in the governance of the national and global economy. Similarly, this neo-classical tendency normalizes the adoption of certain policies and institutions, as well as implies that there is no alternative solution. In contrast, I want to enlighten how the chosen policies and institutions serve to certain interests in the American society and how they were promoted by these groups in a complex and dynamic relation with the broader public.

Ideas are an integral part of these political processes and enable powerful actors to justify their interests in the political realm. Hence, ideas do not stand outside the political world but are a part of them in a dynamic manner: They both shape and be shaped by political and economic events. The rise of monetarist and neo-classical policies in the 1970s was an outcome of intellectual attempts of Friedrich Hayek and Milton Friedman to support fiscal conservatism and minimal government. These ideas turned out to be major guidelines for the economic policies pursued in the post-1973 era. Neo-classical ideas founded the theoretical justification of major tax-cuts, reduction in welfare spending and deregulation of financial markets. However, it is also evident that the supply shock of 1970s indicated the unsustainability of Keynesian compromise. To the extent that Keynesian policies did not answer to resolve the problems of stagflation in the world economy and in the US, more and more political actors turned into these monetarist theories to overcome stagflation and the broader public could be more easily convinced for a major policy paradigm change.

Focusing on the political aspects of the financial crisis, I want to place a certain emphasis on democracy as the political regime and the main interest intermediation mechanism. Here, my intention is not to represent the different dimensions of policy-making in a democratic setting such as deliberative and normative aspects. Instead, based on Robert Dahl and Joseph Schumpeter, I take the simplest form of democracy –electoral and/or Schumpeterian- as a representative regime where individuals have right to vote and to be chosen for governmental positions. In other words, I discuss

democracy as the game in town to examine the rules of policy-making in the US and to identify how policies and institutions that constituted the new financial system came into being.

Democratic Origins of Crisis Making

A number of critical observations make the principal research of the thesis particularly important. The historical analysis clearly indicates that most of the legal and institutional changes in the financial realm occurred in the last three decades. These changes allowed financial actors to operate much more liberally both in the national and global contexts. These legal and institutional changes also encouraged new financial instruments to emerge and made credit cheaper and largely available. The changes in the financial realm in the last three decades were also part of a broader neo-liberal turn in American and world politics.[1] The data indicates that three decades impact of these policies are deteriorating income equality, stagnant real wages for middle and lower class Americans, increasing poverty and social problems, as well as increasing household debt. In addition, analysts also stressed how uncertain and volatile financial markets made individuals more vulnerable to market shock with financial crisis (Strange, 1986; 1989). In short, a snapshot picture of neo-liberal policies in the last three decades seems to have worked in contrast to the interests of the broader segments of the society. In contrast, a small minority of

[1] Neo-conservative in the American context. In the following I prefer the term neo-liberal referring to particular policies that stems from monetarist and supply-side economic theories. Neo-liberalism, in general, entails limited government and free market ideology. Therefore, neo-liberals support reduction of tax rates, decline in welfare spending, greater freedom to market actor with deregulation and privatization of state enterprises.

top-income individuals gained considerable improvements in their income and wealth (Piketty and Saez, 2003).

In the light of this evidence, I question how it was politically feasible to legalize and institutionalize the new financial architecture in the democratic setting of the US. In other words, I am particularly interested to give a plausible answer to the puzzle that why the great majority of people in the US at least tacitly consented on the emergence of this new financial architecture that was likely to create a crisis-prone system and deteriorated income equality. Such an analysis needs a well-grounded evaluation of the democratic dynamics in American politics.

It is apparent that the US is a democracy, where citizens have formal rights to shape political outcomes trough a number of democratic means. The most common utilization of democratic rights is voting in the elections by delegating individual rights to a representative. Therefore, choosing one representative over another also means choosing certain polices over other political options. In return, it is also expected that the elected officials would serve to the interests of the electorate taking preferences and demands of the electorate into consideration. In this regard, the simple assumption of the democratic theory necessitates high level of political responsiveness between public opinion –preferences of the electorate- and the political outcomes. However, this simple assumption regarding the democratic governance inadequately explains the complex dynamics of political regimes. It has been evidenced that elites and upper classes intervene into political processes and influence outcomes in democratic regimes. In this light, class-based theories argue

that the economic and political elite in the US have always been able to shape political outcome directly influencing the selection of candidates, lobbying in the Congress, influencing state officials and have a long-term impact in shaping public opinion through media, educational institutions and expertise knowledge.

Another issue with the democratic regimes has always been individuals with respect to the extent to which they are rational, informed about political debates and preferences. Growing body of literature indicates that even if individuals follow the simple definitions of rationality, their level of knowledge about complex dynamics of the political processes are limited. Only rare fraction of the electorate is informed about the public debates over legislations. Similarly, most of the issues are too technical for the large proportion of the electorate and these individuals usually do not have certain preferences over these issues. Only moral and racial issues are largely salient. Most of the electorate usually has certain preferences on a number of issues shaped by prior beliefs and prejudices about racial and moral concerns. In this respect, the rationality of individuals is bounded with information costs. Therefore, simple assumptions of individual rationality does not yield meaningful results to answer why in a democratic system people consented on certain policies that seems to have negative impacts over their well-being. Hence, much more subtle conceptualization of individual rationality would be necessary, which incorporates the possible effects of issue saliency and elite influence over the shaping of public opinion.

Another critical concern with democratic regimes is the existence of patterns in modern societies that shapes political behavior of individuals, political outcomes, and party alignments. Class-based or economic voting theories predict that there should be congruence with the class positions of the individuals and their political behavior. For example, low income-owner electorate is expected to favor more welfare spending and progressive taxation. In contrast, affluent members of the society are generally inclined to favor conservative policies targeting tax cuts and reduction in social spending. In contrast to this general wisdom, growing body of the literature argued that non-material and cultural issues gained prominence in shaping the political behavior of individuals in advanced democracies since the 1970s. In the context of the US, moral and racial issues are particularly emphasized with respect to choices of the electorate. Polls show that moral issues are the most important concern of American electorate when they are deciding on the president (Lange and Cohen 2005). Similarly, Gilens (1995) empirically showed that lower and middle income Americans tend to oppose welfare policies due to racial concerns and the stereotypes that associates African-Americans with laziness and reliance on the government. In this regard, these studies challenge the common wisdom that there is a high level of congruence between class positions and political behavior. For this reason, this thesis will pay particular attention to non-material bases of political behavior in the US to identify why large majority of Americans did not resist long term stagnation of real wages and deteriorating incomes in conjunction with the emergence of new financial order.

Institutional Analysis

The theoretical basis of this thesis is founded on the insights of institutionalism. Chapter 1 is mainly devoted to the debates regarding the institutionalist approaches. After a brief discussion of the institutionalist analysis within its historical evolution in social sciences, I particularly emphasize how new institutionalisms incorporate informal institutions of human coordination and cooperation with formal institutions. In this respect, the central logic of institutions rest on the observation that institutions are the broader rules of game that constraint, shape and structure human interaction and individual behavior. Focusing on the coordination and cooperation problem, institutionalist perspectives stresses the political dimensions of institution building. In this regard, institutionalist explanations particularly in economics fundamentally differed from the neo-classical ones with their emphasis over political nature of economic policies and institutions. Therefore, this perspective is highly consistent with the aims of this thesis that intends to explain the political roots of economic outcomes.

In the first chapter, I introduce two variants of institutionalism and aim to present them with their major characteristics, differences and the criticisms directed toward them. Historical institutionalism can be characterized with its particular reliance over history as an empirical tool to detect the patterns evolved in the past. According to historical institutionalists, history is not a coincidental chain of events. Instead, what happened in the past shapes the present actions of the individuals and groups within the logic of path dependency. This variant of institutionalism also pay due regard to

distributional conflict over resources and examines the role of institutions within the dynamic context of power, interests and ideas. In a sense, institutions are a part of broader distributional conflicts in society. This approach provides many insights to our analysis in many respects: first of all the analysis of historical evolution of international monetary orders, deregulation of finance and the emergence of new financial system applies theoretical insights of historical institutionalism over issues such as distributional conflict; design of institutions within a dynamic interaction with interests, ideas and power in chapter 2; as well the discussion of economic inequality in the US in the third chapter.

Rational choice institutionalism is founded on the rational actor model and methodological individualism. This approach perceives politics as a series of collective action dilemmas among individual actors. Institutions, in this framework, have a particular role to reduce transaction costs for cooperation and coordination in human interaction. In this respect, this approach has a functionalist view of institutions providing the equilibrium for stable cooperation of individuals that punishes free-riding and cheating. I utilized rational choice institutionalist insights especially in explaining the emergence of the new financial system with perverse incentives in chapter 2 and in chapter 4 with to explain why middle and lower income classes might have approved financial deregulation and innovation as a way to compensate their purchasing power.

Macroeconomic Trends in the US

The third chapter of the thesis is mainly devoted to the empirical elaboration of the principle observations that I shared in this introduction. The analysis digging beneath the surface of major macroeconomic figures shows that in the economic equality clearly deteriorated in the US in the last three decades, as evidenced in Gini indicator. During the same period, the US economy maintained stable rates of growth and in most of the years outperformed other advanced industrialized countries. The growth performance was mostly due to the increases in the total factor productivity. However, the merits of the growth were not distributed evenly among the different segments of society. While the top 1% of population in terms of income experiences serious advancement in terms of their income and wealth, for the broader part of the American population the growing economy did not bring wealth and prosperity. Indeed, the real wages were mostly stagnant in the last three decades.

In contrast to the stagnancy in the real wages, the share of consumption in the GDP permanently increased during the same period. A number of studies also showed that it was not only the affluent segment of the society contributed the rise in consumption. Almost all segments increased their level of consumption even though they did not experience real wage growths. In other words, the large bulk of American society spent more than their income. Such an over-consumption was facilitated by the availability of cheap credit options. The changing dynamics of finance –as discussed in chapter 2- encouraged financial actors to create new credit options with higher leverage and new derivative instruments to make higher profits.

The perverse incentive structure in the financial system enabled credit to be cheaper and largely available. The broader segments of American population enjoyed cheap credits to compensate their stagnant wages and to sustain their historically constructed living standards, which meant over-consuming through borrowing. The consumer debt and household debt has risen in the US in recent decades. The US mortgage crisis indicated that how the fragile structure of the new financial order incorporated broader elements of society and provided them with available credits even if these people were not able to pay it back.

Solving the Puzzle?

I argued that there is a puzzling dynamic in the establishment of new financial order as an integral part of neo-liberal policies within a democratic setting. Based on the discussion of democratic theory and political behavior in the US, I have earlier come up with three possible explanations. The first one is the dominance of economic elite in American politics to shape the outcomes. However, empirical studies show that elites do not have a concrete power in shaping political outcomes. Thus, it is hard to claim that the legal and institutional establishment of finance occurred with the influence of upper class elites even if broader segments opposed it. Nor people are totally ignorant of their political preferences and their interests. In a sense, it would be inadequate to claim that people were almost ignorant on every political issue. It is true that most of legislatures regarding financial deregulation require technical expertise and usually the issue saliency is not high. However, people can still identify long term impacts of individual policies. It is naïve to claim that people could not see

that real wages are stagnant almost three decades and small minority of population made a huge fortune. It is also true that the major motivation of electorate have been moral and racial issues rather than economic ones. Nevertheless, a number of studies identified positive correlation with class position and a number of economic attitudes and policy outcomes. These studies showed that lower class mobilization is positively correlated with welfare spending in states. Therefore, even if other factors were important, economic issues have certain impact over political behavior. In short, none of the explanations provide a plausible answer to the puzzle on the point that how it was politically feasible to establish a financial system that is crisis-prone and had negative distributional impacts.

In the fourth chapter, I came up with a new perspective focusing on the role of finance that enables greater majority of American population to spend well beyond their means and compensate their declining purchasing power. I argue that the main reason for the broader segments of American society to be convinced on the institutionalization of the new financial system rests on the fact that the artificial wealth effect of the financial expansion provided this majority to overcome the adversities of stagnant wages and deteriorating income equality. I accept that the former three explanations have an explanatory power. Financial community was effective in mobilizing their power to institutionalize financial deregulation and to remove barriers in front of financial operations. Also, financial issues are largely technical to be easily followed by the public. People were also largely concerned with their moral and racial preferences instead of these financial and economic issues. Arguably, both of these factors worked in a simultaneous fashion leading a

Nash equilibrium of higher financial deregulation and integration, reduction in welfare spending, as well as higher toleration for moral and racial attitudes.

CHAPTER 1

INSTITUTIONALISMS: CONVERGING INSIGHTS, DIVERGING PERSPECTIVES

1. 1. Setting the Corner Stones

Institutions regained considerable attention in economic policy analysis since the 1970s. Indeed, analysis of institutions in political science was not a new enterprise. Political science (especially comparative politics) emerged as a 'science' with an institutional approach -i.e., the analysis of formal institutions such as constitutions, parliamentary structures, bureaucracies etc. This type of institutional analysis, however, only relied on comparison of formal and legal aspects of political life neglecting the political, cultural and social attitudes of individuals and societies. Furthermore, studies utilizing institutionalist framework were almost atheoretical and did not comprise of any generalization and theory-building. In the 1950s and 1960s, behavioral revolution emerged as an intellectual and methodological challenge to this *old institutionalism* and dominated the social sciences with an unprecedented emphasis over individual characteristics, attitudes and behaviors to explain political and social phenomena.

Behavioralist approach, unfortunately, neglected the context within which the individual attitudes and characteristics are shaped. Therefore, behavioralist scholars could not provide satisfying answers to the prior questions of why these political behaviors, attitudes and distribution of resources vary from one country to another (Thelen and Steinmo, 1992: 5). Indeed, revival of institutionalism emerged from the inadequacy of behavioralist approaches to explain national diversities. [2] The apparent diversities within the capitalist systems encouraged comparative political economists to examine the national institutions and structures to better identify the varieties of capitalisms in the age of globalization. These scholars did not deny the convergence effects of globalization that promotes similar institutions for the governance of economies, nonetheless, scholarship in the field of comparative political economy clearly put forth that capitalisms vary with respect to their domestic institutions of state and markets (Hall and Soskice, 2001; Crouch and Streeck, 1997; Kitschelt et.al., 1999; Shonfield, 1969; Schmitter and Lehmbruch, 1979; Katzenstein, 1984, 1985; Evans, Skocpol, and Rueschemeyer, 1985; Steinmo, Thelen, and Longstreth, 1992). These early studies on the national policy styles, neo-corporatism and varieties of capitalisms formed the bases of *new institutionalism* in political science and economics.

The *new institutionalism*, however, did not constitute a unified body of thought and methodology. Rather, it appeared in different disciplines and mostly in isolation from each other. Nonetheless, these new schools of institutionalisms have certain features

[2] On the emergence of 'new institutionalism' in reaction to previous perspectives, see Hall and Taylor (1996) and Thelen and Steinmo (1992). For a broader assessment of the role of institutional analysis in politics and especially in comparative politics, see Chilcote (1981).

that clearly differentiate them from the earlier wave of institutional analysis. Rather than focusing on only formal institutions, these new approaches intended to go beyond the limitations of prior institutional analysis and examined the interaction of formal and informal rules, norms and conventions from the point of group dynamics.

In this sense, the definition and function of institutions in the 'new institutionalist' school differed from the earlier ones. Both schools of 'new institutionalism' agreed on the point that institutions are broader patterns shaping the rules of game in human organization. For example, Douglass C. North, as one of the founders of new institutionalism in economics, stated that "institutions are the rules of the game in a society or, more formally, are the 'humanly devised constraints' that shape human interaction… they structure incentives in human exchange, whether political, social or economic" (North, 1990: 4). North's emphasis on constraints indicates that institutions shape incentive and constraint mechanisms for actors, and hence, lead every actor in the society to expect other actors to behave in a certain way. In other words, the major role of institutions in a society is to reduce uncertainty by establishing a stable –but not necessarily efficient- structure to human interaction. Similarly, a leading historical institutionalist Peter Hall's definition emphasizes the role of institutions in structuring human interaction. According to Hall, institutions are "the formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy" (1986: 19). Thus, institutionalism, elucidating the inadequacy of individual based neo-classical economics and behavioralist social scientific

approaches; stresses the importance of social, political and economic institutions in shaping individual behavior and structuring collective attitudes.

In line with delineating an alternative perspective to the role of institutions, the institutional analysis supplied alternative dimensions for the analysis of policy processes in political economy and economics. Thus, institutional analysis emphasized the political nature of economic policy making. In contrast to the political nature of new institutionalism, neo-classical economics had long rejected the political nature of economic policy-making and represented markets as the provider of efficient outcomes. Market inefficiencies, role of economic institutions (especially state structure) and distributive aspects of economic policies were mostly neglected in the neo-classical approach. As North argued, what has been missing in the neo-classical theory is an understanding of the nature of human coordination and cooperation. The motivations of the individuals are much more complicated than the theory assumed and such a fundamentalist market-oriented approach mostly built its hegemonic status in the field by disregarding ideologies, altruism and self-imposed standards (North, 1990).[3]

In recent decades, growing number of economists responded to this relative inadequacy and unwillingness of classical economic analysis that neglects coordination and cooperation. The emerging interest to the nature of human coordination in the economic and social policy processes necessarily led many institutionalist scholars to delve into organizational issues and operationalization of

[3] For the critique of neo-classical theory, see especially chapter 2 and 3 in North (1990).

institutional variables. Assuming that the political and economic institutions constitute the key mechanisms in determining economic performance and, more importantly, in distributing resources among the participants in the society, scholars of political economy and economic institutionalism paid particular attention to the conflict of interest over institutional design and institutional change. Institutions – either political or economic- have been conceptualized, therefore, as endogenous structures not only shaping policy outcomes and structuring incentives, but by themselves they are outcomes of societal dynamics and also by nature they are policy outcomes.[4] In other words, if different institutions lead to different economic outcomes and varying distribution of economic benefits in society, constituencies and interest groups will attempt to shape the formation of new institutions or remain as the status quo defenders. Arguably, this is the point where politics begins in economic policy analysis.

In the following, I will discuss two variants of institutionalism with respect to their understanding of formation, persistence and change of institutions in dynamic interaction with power, interest and ideas. After a brief summary of the main premises of these new institutionalisms, I will discuss the convergent and divergent points among them. Then, I will conclude the chapter presenting the major criticisms towards institutionalist literature discussing how to make the analysis less vulnerable to the shortcomings of the institutionalism.

[4] For a comprehensive framework of institutions embedded into policy processes with reference to conflict of interest, power and distribution of resources, see Acemoglu, Johnson and Robinson (2006).

1.2. Historical Institutionalism

Historical institutionalism (HI) is one of the main pillars of *new institutionalism* in political science. HI is distinctive with its emphasis over 'to the ways in which institutions structure and shape political behavior and outcomes' (Steinmo, 2008: 1; Hall and Taylor: 937), as well as its particular attention to history as an empirical tool. Although the term, 'historical institutionalism' can be considered as a relatively new term connoting a particular approach, many prior studies of politics and sociology embodied similar characteristics and can easily be called as historical institutionalist. To Steinmo (2008: 6) even the leading scholars such as "Max Weber, Stein Rokkan, David Truman, Karl Polanyi, Alexander Gerschenkron, E. E. Schattschneider or Hugh Heclo would be identified as HI scholars if they were writing today…". Obviously, these scholars did not call themselves as historical institutionalist and defining them as if would be a major anachronistic fallacy. Nonetheless, the point is to show how analyses of institutions in society and politics within a historical perspective have deep roots in social sciences. The role of institutions in historical context has always attracted attention of scholars. However, such a continuation should not lead analysts to disregard the vivid interest appeared in recent decades in the direction to understand the effects of institutions on political behavior and political outcome, using history as the major analytical tool to examine real world outcomes.

The historical institutionalism in political science has also inherited many from the aforementioned scholars with regard to the role of interest and distributive conflicts

in policy making. Studies with an historical institutionalist label mostly converged on the basic insight that "conflict among rival groups for scarce resources lies at the heart of politics… institutional organization of the polity and economy structures conflict so as to privilege some interests while demobilizing others" (Hall and Taylor: 937). However, HI scholars were aware of the incapability and inconsistency of interest-based pluralist theories mostly neglecting institutions and especially state structure. These pluralist interest intermediation theories neglected the context within which interests are shaped and mostly perceived state as an umpire (Dahl, 1978). As a reaction to these pluralist accounts, many HI scholars argued that institutions not only mediate interests but also shape them (Steinmo, 1992: 2; Hall, 1986: 19). In other words, to HI scholars, institutions not only constitute the particular mechanisms for interest intermediation but also influence individual and group interests. In line with the centrality of institutions in their analysis in shaping interests and goals of actors, HI scholars led to a reviving awareness of the state structure and its effects on policy-making. States were no longer seen as 'a neutral broker among competing interests but as a complex of institutions capable of structuring the character and outcomes of group conflict' (Hall and Taylor: 938; Evans 1985; Krasner 1980). March and Olsen (1989: 17-18) also argued that 'the state is not only affected by society but also affects it (see also Aspinwall and Schneider: 8; Skocpol, 1985). In short, what makes HI scholars institutionalists is their perception of institutions at the center of politics shaping political preferences, behavior and outcomes.

Historical institutionalists are also 'historical' in the sense that they perceive history not as a coincidental chain of events and use history as their main analytical and

empirical tool. The concept of *path dependency* has a central role in historical analysis of institutions. Sewell (1996: 262-3) states that "what happened at an earlier point of time will affect the outcomes of a sequence of events occurring at a later point in time". Thus, analysis regarding the social phenomena should incorporate time as a major independent variable that has serious effects on the outcome (Pierson, 2004). Recent studies in this field aim to assess how process, sequence, and temporality can best be incorporated into social explanation (Mahoney, 2000). Accordingly, this new literature is quite critical to the vague definition of path dependency and the role of time in social analysis. To them (Mahoney 2000; Pierson, 2004), path dependency refers more than the vague notion that 'history matters' and 'the past influences the future'. Rather, careful analysis should incorporate causal processes, contingent occurrences and how dynamics of inertia emerges with the path formation. For instance, Mahoney (2000) argues that once an institutional pattern adopted, it delivers increasing benefits with its continued adoption, and thus over time it becomes more and more difficult to change the pattern even though alternative options are much more efficient. Alternatively, to Mahoney, chain of temporally event might occur in reaction to each other. Thus sequence turn into a part of process.

Recent studies in the analysis of path dependency and the role of time in social analysis seem to shed light upon new perspectives. However, for our purposes, it is much more central to summarize what really history means for institutionalist analysis. Steinmo (2008) provides a useful framework for the role of history and how it can be integrated into institutionalist approaches. Steinmo (2008) argues that

history matters at least in three important ways: First of all, political events cannot be thought of without their historical context. Historical events have direct consequences for decisions of actors. Steinmo reminds us the seminal study by Alexander Gerschenkron (1962), *The Economic Backwardness in Historical Perspective,* in which the author argued that development and industrialization strategies of latecomers do and should differ from early industrializing countries. Gersehnkron successfully showed that 'when a country industrializes necessarily affects how it industrializes'. In this regard, the policies and decisions of policy-makers are not time-independent and generalizable. According to Steinmo, the second reason why history matters is the existence of learning processes. Behavior, attitudes and decisions of actors are shaped within a social, cultural and political context. Hence, actor behavior is not time-independent; in contrast it is a function of social interaction, and more precisely social learning. Last but not least, expectations of actors are 'moulded by past experiences' (2008: 12). Actors change their preferences, strategies and decisions according to particular institutional frameworks, as well as previous experience. Thus, by this way, history turns out to be the main analytical and empirical tool to detect particular changes and continuities in actor behavior and institutional formation.

The definition of institutions in HI is much broader compared to its counterpart and incorporates power, interests and ideas. Integrating these other factors on the one hand extends the ability of institutional analysis to explain a particular phenomenon, however, on the hand, lead to an ambiguity which comes first and how these factors can be separated in order to determine to what extent institutions are the real causes.

Endogeneity, thus, appears in this type of institutionalist analysis and I will discuss this issue in detail in the following parts of this chapter. However, HI scholars partly disregarding the methodological concerns, prefer not to take institutions apart from their embedded context. To them, history is the playing ground within which institutions are shaped endogenously and influences outcomes in connection with power, interests and ideas. Much more fundamentally, history provides analytical and empirical tools to identify how institutions, interest, power and ideas interact with each other to shape political outcomes.

Analysis of power, especially asymmetrical power, has a prominent role in historical institutionalism. As Hall and Taylor (1996: 941) argues, institutions distribute power unevenly across social groups, giving "some groups or interests disproportionate access to the decision-making process". Power is decisive in the formation and persistence of institutions but also these institutions determine the power distribution in the future. Similarly, interests have a key role in historical institutionalist analysis. As argued above, interests do not only shape institutions, but also are structured by institutions. Thus, there is a dynamic relationship between interests and institutions that HI scholars want to elucidate. More importantly, ideas are also integral part of institutional analysis. Particularly, HI scholars examined how Keynesian *ideas* on economic policy-making lost its significance vis-à-vis monetarist theories following the 1970s (Hall, 1989; Hall, 1992; Blyth, 2002). According to this literature, supporters of neo-liberal globalization criticized capital controls and the broader role of government intervention into economy, defending free-floating exchange rates and liberal financial markets. These new monetarist ideas were championed by the

interest groups who have direct interest in financial globalization (Helleiner, 2005). Historical institutionalism, thus, emphasized the importance of examining interest, power and the transformative role of ideas to explain the major institutional changes, as well as persistence. HI approach contributed many to social sciences in general and to comparative political economy in particular with its careful emphasis over the path dependence and importance of history in line with its framework how interests, power and ideas are integrative aspects of political processes.

1.3. Rational Choice Institutionalism

Rational choice institutionalism (RCI) does not constitute a unified body of thought like its counterpart HI. Partly such diversity stems from the fact that RCI emerged from different literatures and approaches. Precisely, the main contribution came from the traditional rational choice scholars like Anthony Downs and Mancur Olson. While Downs in his seminal book *An Economic Theory of Democracy* (1957) introduced median-voter theorem (more fundamentally spatial modeling in voting and electoral processes); Mancur Olson in *The Logic of Collective Action* (1965) delved into collective action dilemmas such as free-rider problem, collective goods, as well as strategic interaction.[5] These were seminal studies in social and political sciences in modeling individual and collective action. Downs and Olson provided analysts many tools to examine social behavior with new lenses. Neo-classical economic insights and methodological individualism apparently constituted the backbone of these early studies in rational choice. However, as Levi (1997: 22)

[5] For a broader overview of rational choice in political science see Levi (1997)

argues, rational choice was not only neo-classical economics. "Its attention to institutions and norms, richness of context, to questions of conflict and power, and, on occasion, to non-egoistic motivations differentiates it sharply from the straightforward neo-classical approach". [6] By this way, these scholars opened new dimension for social analysis based on individual preferences with similar emphasis over societal/collective behavior, group dynamics, as well as context within which individual preferences are formed and intermediated.

The insights from game theory were also helpful in modeling strategic interaction in RCI literature. If individuals make decisions aware of the fact that the outcome is also influenced by other actors' decisions, then the formal models should deal with strategic interaction and changing preferences of individuals, which non-cooperative game theory provide many insights. For example, "the 'prisoner's dilemma' and other socially problematic game situations such as the 'centipede' or the 'chicken game' are some of the famous metaphors with which rational choice researchers have analyzed the tension between individual and social interests" (Aspinwall and Schneider: 11). As such, RCI scholars extended the conventional wisdom of rational choice. Nevertheless, what non-cooperative game theory predicts was inconsistent with the social phenomenon in many cases. People were much more cooperative than the theory assumes and predicts. One of the puzzles that required explanation was the fact that the Congressmen usually cooperate without cheating and free-riding in the legislative process. However, the predicts that even if every Congressman benefits from cooperation, cheating while everyone else choose to cooperate is the best

[6] On this point see also Bates (1988)

strategy for rational actors. On the other hand, since every Congressman have tendency to cheat in the time of cooperation to maximize its utility, the coalitions are either futile or unstable. Since the theory predicts that cooperation is expected to be unstable, the persistence of coalitions in the Congress over several issues was particularly remarkable and attracted many scholars' attention to delve into the issue. Indeed, studies on American Congressional behavior created the particular literature upon which rational choice institutionalism arose. To Hall and Taylor (1996: 942-943):

> "…if conventional rational choice postulates are correct, it should be difficult to secure stable majorities for legislation in the US Congress… However, Congressional outcomes actually show considerable stability…for an answer they [analysts] turned to institutions. Many began to argue that stable majorities could be found for legislation because of the way in which the rules of procedure and committees of Congress structure the choices and information available to its members".

The major insight of these studies was remarkable: institutions were effective in solving collective action dilemmas. To prevent cheating and free-riding, committees were established in order to structure and constraint individual behavior. Designing an institution to prevent cheating and free-riding was functional due to the fact that such behavior is easily monitored and punished in this institutional framework. By this way, cheating would be much more costly and the information costs for every other actor would reduce.

Similarly, economists from 'new institutionalist' school analyzed how institutions reduce transaction, information and measurement costs, thereby, reducing uncertainty for actors. Especially North (1981, 1990) built his theory of institutions on transaction costs theory. To North (1990: 27), "the costliness of information is the key to the costs of transacting, which consists of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements".[7] Thus, institutions and institutional innovation are conceptualized as to serve certain functions in the society. Such a functional view of institutions was also consistent with the idea why and how self-interested actors establish certain institutions. It is also explanatory why actors prefer status quo in the sense that supporting existing institutions and resisting alternative ones to emerge. Nonetheless, such a functional view of institutions in RCI mostly neglected the power relations behind the institutional formation and persistence. It is assumed that many institutions emerge and remain useful since it provides utility for societal actors. However, recent studies in this literature criticize this functional view of institutions and question whether to whom these institutions are beneficial (see Moe, 2005).

Based on the heritage of game theory, rational choice in social sciences and neo-classical economics, RCI emerged as one of the main approaches in social sciences within last three decades. Although diverse perspectives exist within the literature, these differences mostly stem from peripheral concerns and out of the scope of this chapter. Thus, major premises of RCI can be summarized as follows: First of all,

[7] On the role of transaction costs, see also Williamson (1985).

individuals and their preferences are at the center of RCI analysis. Individuals have certain fixed preferences and as rational actors try to maximize their self-interest. Nonetheless, the conceptualization of preferences is much more complex than the neoclassical economics. Actors not only decide on the basis of their preferences but also take other actors' decision and preferences into account. Thereby, they do not only 'act' but 'act strategically'. Thus, actor preferences and strategies may well change, as well, according to the rules of the game -institutions. Thirdly, politics is conceptualized as a series of collective action dilemmas. Institutions are part of RCI analysis to the extent that they are functional in solving such dilemmas. I have previously discussed how concepts such as free-rider problem, tragedy of commons, public goods problem provide new insights for the analysis of institutions and politics. The earlier studies indicated that neither individual interests are equal to collective interests (Olson, 1965) nor even collective action is maintained, that does necessarily lead to collective good (Arrow, 1951). More importantly, these concepts complement North's theory of transaction costs linking why and how actors prefer institutions to solve collective action problems.[8] Hence, as a fourth feature, it may well be argued that RCI have strong functionalist essence stressing the role of institutions in reducing transaction cost. Indeed, their presence is explained through their function.

Another major characteristic of RCI studies rests on the attention given to methodological issues. Studies in this framework are generally inclined to pay

[8] For a broader assessment of the certain features of rational choice institutionalism see Hall and Taylor (1996) and Levi (1997).

attention parsimony instead of explaining complexity. Discussing the rational choice perspective in comparative political research, Levi observes that "what divides rationalists from culturalists and structuralists is not method in the sense of mathematics versus statistics, fieldwork, observation, and archival research; there are many rationalists who rely on precisely these tools. What divides them is method in the sense of how to construct theory, organize research findings, and address the issues of falsifiability and plausibility" (Levi: 36). RCI scholars targets to explain the role of institutional variable within a clear and evident framework of actors, interests and strategic interaction rather than evaluating the complex dynamics of political dynamics. Similarly, RCI scholars usually tend to build generalizable hypotheses and test them on the scientific grounds rather than explaining single-cases or specific real world problems.

1.4. Comparing Institutionalisms

I have discussed the main tenets of historical and rational choice variants in institutional analysis, how they emerge from earlier traditions and how they conceptualize interest, power and ideas in their framework. I have not yet clearly pointed out how these variants have similar and diverse understanding of institutions regarding their emergence, persistence and change, in line with the methodological differences. In this part, I will discuss the similarities and complementarities of both variants stressing how some eclectic research programs eroded the walls that differentiate these alternative types of institutions. At the same time, I will intend to

detect to which axes dividing walls between rational choice and historical variants passes through.

In recent years, many RCI scholars realized the insufficiency of rational choice approaches in identifying the specific contexts within which political and social events occur. Traditionally, rational choice analysis has been based on deductive reasoning, formal modeling and hypotheses testing. However, a group of researchers -leaded by Robert Bates, Margaret Levi, Avner Greif and Barry Weingast- became proponents of an eclectic approach –what they call *analytic narratives*. These scholars argued that the strength of rational choice analysis with its emphasis over scientific rigor, plausibility, generalization and theory-building should be integrated with the merits of historical institutional analysis that pay particular attention to the contextual knowledge (Bates et.al., 1998; 2000). Hence, their intention is to develop systemic explanations based on case studies. In doing so, they combine rational choice and historical institutionalisms (Thelen, 1999).

Some HI scholars, as well, have particularly been influenced how rational choice institutionalism pay specific attention to the micro-foundations of politics and conceptualize politics as a series of collective action dilemmas. Many HI scholars, even though they did not adopt the formal methodology of RCI, stressed the organizational factors in the emergence and persistence of institutions (Thelen, 1999; Rothstein, 1996). These cross-border borrowings among historical and rational choice scholars not only pointed out the similarities and complementarities among

two variants of institutionalist analysis, but also implied the major dividing lines between them.

The major dividing line between rational choice and historical institutionalisms is their methodological and epistemological differences. RCI is mostly based on theoretical foundations, however in HI, theory remains rather peripheral. Instead, HI scholars stress the importance of empirical and contextual knowledge based on careful case studies. Such an approach is criticized by RCI scholars on the ground that historical institutionalism has no theoretical framework and these scholars merely telling stories. However, others critiqued RCI's overemphasis of theory arguing that rational choice produces elegant theories but less capable of explaining real events (Green and Shapiro, 1994). Indeed, historical institutionalism is not only story-telling and rejects any theoretical framework. The controversy arises what rational choice scholars expect from a theory. To RCI scholars, theory is and should be universally generalizable. However, theories in HI are only *mid-range* theories and they arise from the real world problems. But in RCI, theories are deductive and hypotheses are formed at the theoretical level. Even though, the methodological and epistemological dividing lines in the literature reflects a partial reality, nonetheless, serious scholarship pays attention to both theory and empirical data in each variant of institutionalism as I showed discussing cross-border interaction among historical and rational choice institutionalist scholars.

Similarly, historical and rational choice variants diverge on the epistemological question in answering how aggregate outcomes can be explained. RCI stresses that

aggregate outcomes need to be understood focusing on the actions and behaviors of individuals (Thelen, 1999: 377). However, historical institutionalists argue that aggregate outcomes and collective behavior cannot be based on individual behavior and action. Structure determines and shapes the collective behavior and outcome. Yet, it does not clearly answer how aggregate outcome come along. HI scholars are also insufficient to address human agency problem in their structuralist framework. What they broadly argue is that sum of individual preferences is not equal to the aggregate outcome. Therefore, while RCI starts with individuals and try to understand how their preferences form institutions; HI starts from institutions and aims to delineate how institutions shape interest. Accordingly, RCI emphasizes micro-foundations of institutionalist analysis, whereas, HI focus on macro-historical research. This initial epistemological controversy reveals itself much more explicitly in the debate on preferences and interests.

Thus, second dividing line between rational choice and historical institutionalism stems from the conceptualization of preferences and interests. I have discussed how preferences and interests are conceptualized in these two different literatures. Therefore, to avoid repetition, I only underline the stark difference without delving into the issue. In rational choice preferences are exogenous and individuals have certain fixed preferences. Institutions do only have role in mediating or transmitting the preferences and interests of individuals and groups. However, in historical institutionalism, interests and preferences are endogenous. In other words, institutions shape and structure preferences and interests of individuals and collectivities.

1.5. A Critical Perspective

In the previous section, I compared the two strands of institutionalism both to indicate their differences and to point out the merits and shortcomings of these two alternative perspectives. In this part, I further examine the criticisms that have been directed to these perspectives. Such an analysis is likely to yield positive results for the careful application of the theoretical framework to the case study. As such, it is useful to identify the limitations of the theory put forth to explain complex structures.

Institutionalism has been criticized on the grounds that its ability to explain the transformative role of ideas is limited; that it yields reductionist and structuralist hypotheses; cannot successfully solve the problem of endogeneity. *The first shortcoming* in institutionalist literature is the lack of clear conceptualization of how, why and when ideas have explanatory power for the formation, persistence and change of institutions. Scholars who stress the role of ideas and ideational factors in social sciences have long been criticizing institutionalist scholars on the ground that these institutionalist accounts use ideas as “fillers or auxiliary hypotheses to solve preexisting problems within their respective research programs” (Blyth, 2002: 17). Indeed, these institutionalist schools take interest at the center of their analysis and treat ideas as if they are different than interests. Accordingly, these accounts are reductionist in terms of failing to identify the underlying factors behind material interests (Lieberman, 2002: 698).

This critique of institutionalism reveals that both historical and rational choice individualisms integrate ideas to their analyses of institutions. Nonetheless, both variants are insufficient to explain why, how and when ideas become prominent in shaping institutions. For instance, Campbell and Pedersen (2001: 161) argues that historical institutionalist tradition rests on the heritage of earlier materialist and structuralist analyses, therefore, material interests of political and economic actors are central to the policy outcomes. Even the historical institutionalist accounts with an emphasis on the role of ideas only limited themselves with the basic premise that the "power of ideas depends largely on how much support they receive from political parties, unions, the business community and from influential political and intellectual elites and how much institutional access these actors have to critical policy-making arenas" (161). Similarly, historical accounts of institutional analysis have been criticized for its emphasis over order and stability. Indeed, HI approach is said to better explain institutional persistence rather than institutional change. Hence, as a part of its theoretical weakness, HI relies on exogenous factors and critical junctures such as economic shocks, natural disasters or wars to explain institutional changes. However, such an approach only focusing on extraordinary factors and events disregards smooth changes and endogenous explanatory factors. Therefore, ideas emerge as the perfect 'fillers' of the shortcomings in HI approach stressing the long-term smooth changes and endogeneity within the institutional change. Although, HI examines how ideas are a part of institutional analysis, yet it cannot reveal a full account of how, when in which contexts ideas become prominent in institutional analysis.

Recent studies in rational choice institutionalism (RCI) also integrate ideas as a part of their formal analyses. In these accounts, ideas are perceived as functional devices for cooperation, focal points for convergence and normative context to define interests. I have pointed out before how RCI emerged from the congressional analysis and the basic question of how stability is maintained in the Congress unlike the high level of instability that rational choice theory predicts. Institutions invoked to solve the paradox of stability in the Congress as a mechanism of stability and persistence. To these RCI analyses of the Congress, institutional arrangements such as committees arranged in a way to constraint free-riders and promote cooperation among congressmen. However, as Blyth (2002) argues, it was soon appreciated that if institutions are themselves instrumental products or policy outcomes, then they are also part of collective action problem. Therefore, rational choice insight should provide an endogenous mechanism for institutional supply. Following this logic, RCI scholars turn to ideational variables to explain how individuals converge on certain focal points, how institutions function in this convergence and how they shape actor interests. Similarly, many rational choice analysts increasingly accepted the view that cultural and ideational factors may form the basis for the preferences of actors. In this respect, ideas, norms, values and habits have been adopted by these scholars and used much more frequently.

Based on the previous critiques to half-hearted integration of ideas in institutionalism, scholars stressing the importance of ideational factors in shaping individual behavior and institutional outcomes, put a much more thorough account of how ideas play a central role in institutional formation, persistence and change. Mark

Blyth (2002) argues that in times of critical junctures (economic crises, wars) ideas – not institutions- helps to reduce uncertainty and make collective action and coalition possible. Moreover, ideas are weapons for struggle over existing institutions. While some new ideas act as institutional blueprints, some serve to make institutions stable. In short, ideas need further attention than the institutionalism had paid in last three decades.

The second shortcoming in the institutionalist literature is the absence of a clear causal mechanism for the institutions and policy outcomes. The form and functioning of institutions, in other words, depend on the conditions under which they emerge and endure (Przeworski, 2004). Hence, institutional analysis suffers from high level of endogeneity. If institutions are not causal effects of particular policy outcomes, then they are only transmitters of the effects of initial conditions upon policy outcomes. Accordingly, if different institutions are possible under different conditions, how is it possible to know to what extent institutions matter and conditions do not (2004: 530)?

Institutions do not only affect individual and group behavior but also an outcome of these behaviors. Institutional formation, therefore, represents the power relations and the interests of powerful groups in the society or in the international system. Obviously, the powerful intends to consolidate and legitimize its power through institutions. If simply define institutions as the rule of the game, powerful, in a sense, defines these rules. Normally, these rules are expected to yield positive results for the ones who designed them. Democratic mechanisms for election and electoral systems

are of such type institutional designs meant to produce advantageous results for those who designed them. For example, gerrymandering is to modify or change electoral districts to produce electoral success even though the total number of votes does not increase. Similarly, electoral thresholds are institutional designs of moderate parties who have already gained the large bulk of votes and able to change institutions in order to marginalize radical parties and block them to enter into parliament. Similar patterns can be observed in the constitutional design. Constitutional constraints are the main guidelines for the policy-making in national contexts. These principles indicate how the powerful actors who designed them intend to remain powerful through certain mechanisms. In this respect, it is not surprising that many military interventions ended up with constitutions designed by the influence of military. One of the identifiable elements of these constitutions is the existence of articles that enable military to persist its powerful role even in the democratic settings. Similarly, constitutional constraints restricting or prohibiting the ability of democratically elected policy makers to judge the military personnel who engaged in the coup, has always been one of the essential incentives for the military to turn into barracks. In short, a complete account of institutionalist analysis should carefully consider the hidden power relations in the formation of institutions.

Aware of the endogenous nature of institutions, careful analysis should pay further attention to underlying dynamics and conditions. In this respect, criticizing the lack of power analysis in RCI, Terry Moe argues that institutions can be mainly explained by distributional conflicts. RCI tends to define institutions as cooperative arrangements. However, to Moe, most democratic institutions are often not

cooperative or mutually beneficial. Rather, they involve exercise of power (2005: 218). Solving the controversy surrounding the endogenous nature of institutions at the theoretical level seems to be a challenging effort if not impossible. Nonetheless, a case study with serious historical and contextual background may help to reduce endogeneity problem and identify to what extent political economic conditions led to the formation of certain institutions and how these institutions, in turn, led to particular policy outcomes. In other words, endogeneity problem occurring at the abstract level may yield to a fruitful analysis at the empirical level contributing to the analysis of dynamic interaction between conditions, institutions and outcomes.

The third shortcoming in institutionalism is the over-emphasis on structure and partial neglect of human agency. This neglect is much more apparent especially in historical institutionalism but a reductionist understanding of politics and political behavior that assumes away any complexity is common feature of institutionalist analysis (Lieberman, 2002). These accounts fail to explain how human agency can defy the constraints of political and social structures and how these agents are able to create new possibilities for political outcomes and institutions. Indeed, structure and agency debate is not unique to institutionalism. The controversy remains as one of the major debates in social sciences and manifests itself in various literatures. The debate does not seem to end with a plausible solution. On the one hand, structuralists argue that structural factors as class, religion, gender and ethnicity determine the actions of individuals. On the other hand, proponents of agency stress the capacity of individual agents to decide on their actions even though these are contrary to what 'structure' promotes them to do. Much more complex analyses on structure and

agency emphasize how agency and structure complement each other arguing that structure constraints individual behavior, whereas, humans are capable to of changing the structures that constraint them. Institutional analysis has a tendency to overlook individual agency in order to determine broader patterns shaping political behavior. However, the role of individuals and their agency are particularly important to explain institutional change. Hence, an institutional analysis should be able to identify both how institutions constrain individual behavior and how individuals are capable of changing the rules and institutions that bind them.

1.6. Applying Institutionalist Theory

This thesis examines how a new financial system emerged in the US within a democratic setting. One the one hand, the emergence of this new financial system has been embodied with legal and institutional changes in the international monetary systems and national regulations. These changes encouraged new forms of financial instruments and stimulated new dynamics in banking operations. Therefore, all of these legal and institutional changes required a process of democratic approval in the Congress and in other governmental institutions. On the other hand, impacts of these changes in the financial realm (alongside with other neo-liberal policies) deteriorated income equality and increased economic volatility and uncertainty. The emergence of the new financial order within a democratic setting, then, necessarily entails a puzzling relationship: how it was politically feasible to institutionalize a financial system that seems to have long-term, direct negative impacts over the larger segments of American society?

The institutionalist theory provides a framework to discuss this puzzling relationship. First of all, the central emphasis of institutionalism on the political nature of economic policies provides a general framework for the distribution of power and resources in society. Unlike the approaches grounded in neo-classical economy that identify right and wrong economic policies, the institutionalist framework perceives economic polices with their distributional outcomes. In this perspective, powerful actors intend to secure their existing power with long-term institutions and legal changes. I applied this major notion in many parts of the thesis. I discussed the major institutional changes in the domain of international monetary regimes and finance with respect to distribution of power among actors and their expected benefits from these institutions. I argued that one of the major reasons for the establishment of the Bretton Woods was the domestic New Deal coalition in the US that preferred exchange rate stability and liberal trade order. Having seriously damaged in the aftermath of the Great Depression, this coalition opposed flexible exchange rates and financial openness. In contrast, the end of Bretton Woods system and the following regulatory reforms entailed a great political pressure of international financial community in the US. In other words, the legal and institutional changes transformed *de facto* power of financial community to *de jure* power.

Institutionalist emphasis over the dynamic relationship of actors, interests, power and institutions provides a theoretical ground to discuss how these financial changes emerged within a historical context. For example, in chapter 2, I discuss the end of Bretton Woods system and the deregulation of finance in the US not only focusing

on the material interests of financial community. I also emphasized how newly emerging monetarist ideas gained prominence throughout the 1970s and replaced Keynesian embedded liberal order. Economic stagflation in the 1970s further encouraged policy makers to abandon Keynesian policies and adopt the monetarist policies with mainly practical concerns. The account I presented here does not solely lean on alternative materialist or ideational factors. Rather I discussed how these two elements interacted with each other and lead to a major policy change in the 1970s.

I also frequently used rational choice institutionalist insights on the basis of how actions of rational actors might be misguided and create bubble-like dynamics with the design of institutions and the perverse incentives within. The discussion of perverse incentives in chapter 2 regarding the new financial system indicates that financial firms no longer insist on capital adequacy ratios and the trustworthiness of the borrower. Rather they focus on fee income that is obtained after each transaction. The 'originate and distribute' model stimulated new financial instruments and extreme risk taking with higher leverage ratios under competitive environment. The major incentive of these top managers in the financial firms have been to engage in this extreme risk-taking process because it increases firm profits, provides bonuses and extra income. Even if these managers were not aware of the risks associated with new financial derivatives or they know that such a trend would likely to end up with a financial crisis, opting out of the process was not a possible option. Similarly, ordinary citizens enjoyed cheap and easily available credit and further stimulated the bubble. The virtuous cycle of easy credit, rising housing prices and extra leverage ended up with credit crunch sub-prime mortgage crisis in 2007.

Rational insights also provide a plausible answer to the major puzzle presented in this thesis. The reason why middle and lower class individuals tacitly consented on the emergence of new financial architecture may be the case that cheap and easily available credit that was provided with financial deregulation and innovation help these individuals to compensate their long-term stagnant real wages and income inequality. In chapter 3, I provide evidence for the rising trends in economic inequality, household consumption and debt linking these patterns with historically standard norms and stagnant wages. It is evident that easy borrowing options helped individuals to compensate their losses in terms of stagnant wages and income inequality. Through extreme borrowing, larger segments of American society persisted to consume in an increasing manner. In this manner, insights from rational choice institutionalism help me to come up with equilibrium or bargaining model that argues middle and lower class Americans might have preferred short-term financial benefits over long-term objective of economic equality and rising real wages under certain constraints and with non-material preferences. I discuss democratic responsiveness, rationality assumption and non-material bases of political behavior to complement this model and to clarify the constraints and other preferences in the model.

1.7. Conclusion

This chapter provided an overview of the institutionalist theory that will be utilized throughout the thesis. Presenting an account of the historical development of the

theory and the intellectual debates regarding the older and new forms, I argued that new institutionalism is clearly distinctive with it emphasis over informal institutions and how these informal structures constraint individual behavior. In this manner, these new institutionalist theories focused on the theoretical justification for human coordination and organization in order to explain political behavior and the emergence of institutions.

This theoretical overview particularly examined historical and rational choice variants of institutionalism with the practical justification that the insights of these two perspectives will be utilized and harmonized frequently in the following chapters. This does not anyway mean that sociological institutionalism is not equally valuable or does not have an explanatory power to delineate why individuals tend to found institutions and how these institutions shape individual behavior. Rather, this theoretical choice stemmed from the fact that my interest and belief that careful examination of preference based actions throughout historical processes would yield fruitful results regarding the financial crisis. Nonetheless, I also borrow and adopt sociological factors in my analysis, particularly in the third chapter with reference to historically constructed life standards of middle class American families. Yet, the rest of the analysis mostly lean on rational choice and historical institutionalist insights.

A simple overview of the literature indicated that the gist of the historical institutionalism rests on the study of institutions with particular emphasis on how these institutions shape and structure political behavior and outcomes. Historical

institutionalist scholars do no perceive and conceptualize history as an accidental chain of events. Rather, history is a complex but meaningful amalgam of action and outcomes, in which actors should take their previous actions and preferences into account. The concept of path dependency may be useful, in this respect, to explain how particular choices at certain point of history affect the outcomes today. With reference to these justifications and causal mechanisms, historical institutionalist scholars argue that historical analysis is not merely story telling. Instead, history is a particular empirical tool and a methodology to examine institutions and their role in social and political life.

On the other hand, rational choice institutionalism -as briefly summarized in this account- is based on the rational actor model with emphasis over preferences and interests. Borrowing from cooperative game theory, rational choice scholars examined political process as a series of collective action dilemmas. Institutions, in these accounts, constituted a specific role to solve these dilemmas. Institutions are conceptualized as the constraints to shape actor behavior by reducing transaction costs and enabling actors to cooperate in a setting, where rules are a priori defined and cheating or free-riding can be easily observed and punished.

This overview also intended to compare these two variants and simply discussed the ways to combine the merits of both. The analysis showed that while rational choice perspective is characterized with broad theoretical generalization, historical institutionalism usually focus on real world problems and come up with mid-range theories. In this respect, I can argue that my analysis of financial crisis and its causes

in the US mostly lean on the former perspective in the sense that my questions arise out of a real problem and I utilize mid-range theories to provide a meaningful answer to the empirical puzzle instead of coming up with a major universal and generalizable answers.

This part also brought the relevant critiques of institutionalism into the agenda with the major incentive that a general awareness of the theoretical limitations may help to refine the analysis and provides extra leverage for the explanation of the phenomenon. In this respect, I paid particular attention how ideas affect the emergence of institutions. The Keynesian influence was particularly evident in the formation of Bretton Woods international monetary order in the postwar era. These ideas also justified government intervention into the economy and encouraged social spending and income equality. In contrast, monetarist (broadly neo-liberal) policies encouraged tight monetary policy, tax cuts, reduction in welfare spending and less government intervention. These ideas shaped the institutions and policies of post-1973 era with the political outcomes of ending Bretton Woods system and introduction of flexible exchange rates, deregulation of finance and increasing income inequality in the US.

CHAPTER 2

THE NEW FINANCIAL ARCHITECTURE: DOMESTIC AND INTERNATIONAL TRANSFORMATIONS

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."
> (Financial Times, 2007 quoted in Crotty, 2009).

This chapter provides a framework to discuss the financial crisis and to identify the possible causes of credit crunch in the US, examining the broader changes in the international monetary system, financial regulation and banking practices. A complete account of the financial crisis would be inadequate without considering these dimensions due to the fact that many economists also pointed out the structural reasons of the current crisis with particular attention to volatility in the system due to new financial derivatives, lack of regulation and perverse incentives.[9] In a similar vein, others stressed how historical evolution of exchange rate regimes and international monetary orders from fixed exchange rates to free-floating exchange

[9] The recent issue (33) of Cambridge Journal of Economics is devoted to the financial crisis. Most of the authors in this issue discussed how perverse incentives of the new financial architecture created the dynamics for extreme leverage in the financial operations, which at the end created the sub-prime mortgage crisis and the credit crunch.

rates stimulated globalization and deregulation of finance, allowing bankers to introduce new financial tools, increasing leverage and involving into risky practices (Broz and Frieden, 2001; D'Arista, 2009). The common insight obtained from these studies is the necessity of discussing the recent changes in the financial practices within a broader framework of changes in the international monetary order and domestic regulations. Furthermore, it is particularly important that these international and domestic levels are linked to each other, especially with regard to the US, which is able to influence the global system more than any other nation state. Hence, the following analysis will discuss the evolution of international monetary system, the deregulation of finance in the US and the new financial architecture.

Institutionalist theory provides a framework for such an analysis with its emphasis over the dynamic interaction of institutions with actors, power, interests and ideologies. In this framework, not only the actors shape institutions within the confines of their interests, power and guiding role of their ideologies; but also institutions shape the interests of actors and guide them to behave in a certain way. For example, the private and national actors were the ones who designed the Bretton Woods system as an institution to secure global trade and financial flows. However, to encourage global trade and help economic recovery within a democratic environment, the designers of Bretton Woods preferred trade over finance. One of the reasons for this political choice and design of institutions rested on the that fact that finance had been perceived as a source of instability due to Thus, the experience of Great Depression and the destruction of international trade in the aftermath. Therefore, Bretton Woods system restricted financial flows with capital controls,

fixed exchange rates, as well as endowed national governments with monetary autonomy to sustain their social welfare policies within a framework of 'embedded liberalism' (Ruggie, 1982). Obviously, the rules and restrictions of this international monetary order shaped the interests of actors and they responded to these changes. For instance, the New York bankers were not allowed to operate as they were in the previous years with the strict regulation of Glass-Stegall Act and Bretton Woods system. However, these international financiers responded to these deteriorating conditions with the creation of Euromarkets, in where they operate without the limitations of national regulatory framework, and carrying their activities to off-balance sheets. Most of the recent financial practices stemmed from the innovative efforts of financiers to circumvent regulations and restrictions of post-war economic order.

Historical analysis of institutions also presents the dynamic interaction of domestic (national) and international levels.[10] This point is particularly relevant with regard to the US as the hegemonic power of the post-war era with the ability to influence – even shape- international regimes and institutions. The establishment of the Bretton Woods system with a restricted international financial order and the narrow banking model in the US is one of the examples of this dynamic interaction of national and international levels. The main remnant of the Great Depression in the US was the general belief that excessive competition and lack of regulation in the financial domain were the main causes of the crisis (Coleman, 1996). This general belief

[10] The interaction of national and international levels has been theorized by IR scholars. For seminal examples, see Putnam (1988) and Moravcsik (1997).

among the actors not only resulted with changes in the domestic realm but shaped the underlying logic of Bretton Woods. Post-war construction of international trade and economic recovery, thus, have been based on the idea that liberal international financial order would not be compatible with a stable system of exchange rates and a liberal trading order (Helleiner, 1994: 5). This perspective also supported by the grand economic theories of John Maynard Keynes who insisted that financial flows should be restricted with capital controls and advised governments that 'let finance be primarily national' (Cerny, 1993: 25-26). The domestic majority in the US supported an international order that restricts finance in line with Keynesian theory. In return, the national regulations of finance in the US also represented the similar features. Glass-Steagall Act provided a strict framework for regulation and separated commercial and investment banks to prevent conflict of interest and perverse incentives. In short, domestic preferences of the US policy-makers over the finance and trade created Bretton Woods international monetary order, which also shaped national regulations of financial practices and capital controls leading to a narrow banking model.

Based on these institutionalist insights, the following analysis will first of all discuss the evolution of international monetary orders. Due to space limitations, I will only focus on Bretton Woods and post-1973 flexible exchange rate system with minor references to previous period (19th and early 20th century classical gold standard and interwar period). In the second part, I will present the regulatory changes in the US in the realm of finance with due regard to the geographical de-segmentation and elimination of strict barriers in financial operations. The third part presents a

discussion of the new financial architecture in the US with new financial instruments and inadequate regulation over financial operations. Indeed, the present situation in the American finance is a result of the broader changes in the international monetary order and weakening of regulation. These are also the major causes of the current crisis.

2.1. Historical Evolution of International Monetary Systems

The world has witnessed three broad international monetary systems in the last 150 years (Broz and Frieden, 2001: 320). These were the pre-WWI classical gold standard, 1940-70 [broadly] Bretton Woods order and post-1973 free floating exchange rate system. Even though a thorough analysis of international monetary systems necessitates a careful examination of each era, due to space limitations I will concentrate on the last two ones. Why I neglect the classical gold standard and rather focus on the last two era stems from my intention to detect how recent changes in the US financial realm occurred within a dynamic interaction with international and national systemic changes. Furthermore, Bretton Woods and the post-1973 orders are the ones that US had a direct hegemonic impact on the establishment, survival and fall of these systems. In this regard, the connections between national and international levels would likely to be more fruitful for these periods. Nevertheless, the discussion of interwar years is necessary - with particular reference to the Great Depression and disruption of international trade- in order to understand why and how Bretton Woods system intend to secure international trade but restricted financial flows.

The interwar years witnessed the disruption of international trade with retaliatory depreciation currencies by national governments after the Great Depression. In the aftermath of the crisis, policy makers and economists mostly consented on the view that international trade can be sustained with stable exchange rates and limited role of finance. Furthermore, New Deal reformers under the leadership of President Franklin D. Roosevelt argued that the Great Depression explicitly showed how private markets would produce negative results when they were left alone. Hence, they supported the governmental management of domestic and international economy (Frieden, 1987: 60-61). The political motivation in the direction of more government involvement to the economy had also been theorized and supported by John Maynard Keynes since late 1930s (Cerny, 1993; Frieden, 1987). For this reason, the central objective of New Deal reformers to create a new international order has been based on free trade with restricted finance and more government involvement overlapped with the Keynesian perspective. Even though the New York financial community opposed the earlier plans of John Maynard Keynes and Harry Dexter White on stable exchanges, capital controls and national fiscal and monetary planning; they were only partially influential in restricting the earlier plans. In short, the erosion of international trade and the perceived destructive outcomes of finance in the interwar years shaped the preferences of policy makers for the design of postwar institutions of international economic order. Arguably, on this historical evidence, it is fair to claim that the emergence of postwar economic order with its governing institutions was not a mere coincidence but an outcome of historical chain of events.

Bretton Woods emerged as the new international monetary order to stabilize international trade, investment and finance in 1944 conference. This new international economic and monetary order had been established under the leadership of the US (D'Arista, 2009; Frieden, 1987, Helleiner, 1994, Cerny, 1993). The central logic of the new system rested on the stable exchange rate mechanism, where the US committed to exchange dollars for gold at the rate of $35 an ounce. Other currencies were pegged to the US dollar at a given exchange rate with the incentive to stabilize currencies and create a stable environment for international trading and investment. Even though the system leaned on fixation of interest, there were regulation to maintain partial flexibility in case of fiscal disequilibrium. For instance, the system of exchange rates was flexible to the extent that other currencies could appreciate or depreciate within a bound of 2% (D'Arista, 2009). Also, countries were allowed to adjust their countries' par value whenever they have serious disequilibrium in their external accounts (Helleiner, 2005). Nonetheless, this flexibility were intended to provide extra leverage to implement trade policy which likely to impede international trade. In other words, the main logic of Bretton Woods system was to secure international trade, create global stability and encourage recovery of national economies within the confines of liberal trading order.

Alongside with the stabilization of international trade and economic recovery, there were also political reasons for the establishment of the Bretton Woods system under the leadership of the US. Helleiner (1994) and Frieden (1987) argue that one of the major strategic objectives of the US is to construct and secure its hegemonic role in

international affairs vis-à-vis the spread of communism. In the aftermath of WWII, Soviets were able to exert its influence not only to Eastern Europe but also to major European nations particularly with social movements and leftist parties. For example, France, Italy and Belgium were under the influence of communist parties with strong support from labor unions and lower social classes. These countries might have approached USSR in the newly emerging Cold War context. For this reason, the new international economic order not only targeted stability of exchange rates but also promoted economic recovery of Europe and Japan. Furthermore, it allowed national governments to preserve their monetary autonomy to sustain welfare spending and secure certain level of legitimacy among society. In a sense, the postwar economic order was never merely a liberal one. Liberal reforms without social dimension would have been destructive and likely to encourage and strengthen socialist movements.

The guiding principles of postwar economic order had been structured by two major institutions: International Monetary Fund (IMF) and International Bank for Reconstruction and Development (IBRD). The major rationale of these institutions (particularly IMF) was to sustain global monetary and financial cooperation (Helleiner, 2005). IMF was particularly designed to solve short-term balance of payment deficits and to smooth the stress for the national governments under fixed exchange rate regime. On the other hand, the main objective of IBRD (lately World Bank) was to provide long-term loans for reconstruction and economic recovery. In short, these institutions were designed to serve two major principles of the Bretton

Woods systems, namely stimulating international trade via stable exchange rates and sustaining economic recovery in Europe and Japan.

Arguably, institutions of the postwar economic order well served to the interests and preferences of their designers in the 1950s and 1960s. The underlying preferences and institutions of postwar monetary and economic order embodied in Bretton Woods system, achieved to stabilize exchange rates and sustained healthy international trading throughout the in this period under the US leadership. Also, European and Japanese economies managed to recover themselves during the same period. In all of these respects, US seem to have achieved its objectives leading to the establishment of the new international economic and monetary order.

On the other hand, the burden of the US as the global hegemonic power to protect the healthy maintenance of the international economic order had been growing. The 1960s were the years that the stress on the external accounts of the US had become evident. The trade balance and other indicators of the US international competitive position showed a decline from 1964 to 1970 (Odell, 1979: 66). The demand for the US dollar as the global currency end up with dollar shortage, over-consumption in the US and the decreasing competitiveness of the US industry vis-à-vis European and Japanese counterparts. Indeed, this point had been predicted by Robert Triffin in 1960; who argued that in a system where the US dollar is the reserve currency, international liquidity can be sustained only when the US provided the world with more dollars. However, providing more dollars means more balance of payments deficit, which at the end undermines the confidence into dollar (Triffin 1960 quoted

in Helleiner 2005). Also, the US dollar had been exposed to numerous speculative attacks in the 1960s. The first dollar crisis occurred in 1960 with the speculative sale of US dollar. Despite the sudden attack on the US dollar, US government resisted to devalue the dollar. Instead, to counter-pressure the downward impact on the US dollar, they introduced the monetary response known as the 'Operation Twist'[11] (D'Arista, 2009). Similarly, in 1967 second run on the dollar emerged, resulting with the Fed policy of raising interest rates to attract foreign funds. Nevertheless, throughout the 1960s, the US government insisted to keep Bretton Woods system and exchange rate stability even though it started to deteriorate US external balances and hamper US competitiveness. In other words, the major designer of the postwar economic order with the most power to influence global economic governance may not be very willingness to sustain the existing institutions.

Within the 1970s, the externals shocks became detrimental for the US economy. However, there was a striking difference at that time. The US officials were no longer willing to maintain exchange rate stability as they were in the 1960s. This change in the preferences of the US policy makers manifested itself in the final decision over policy outcomes and institutions. When speculative attacks reached its peak, the US government had to decide either on cutting back the issuing of the US dollar or ending the convertibility of the dollar to the gold. In December 1971, the US suddenly ended the convertibility of dollar into gold (Helleiner, 2005) and re-pegged exchange rates reducing the average exchange value of dollar by

[11] Operation Twist was the monetary policy implemented by the Federal Reserve in 1961 to increase the value of the US dollar by attracting foreign capital to the US and to counter the speculative sales. For this reason, the Federal Reserve utilized open market operations to reduce the spread between long-term and short term interest rates.

approximately 8% (Odell, 1979). Much more fundamentally, in 1973, the US decided to end the controls on international capital outflows, which means effectively the end of fixed exchange rates and the Bretton Woods system. The international monetary order, then, turned into free-floating exchange rate regime with the removal of its major institution.

Unsustainable balance of payments situation and the decline in competitiveness of the US were not the only factors that made the US policy makers to change their preferences over international monetary policy to end the system that they established three decades ago. Odell (1979) and Cerny (1993) pointed out the changes in the belief systems and ideologies of certain key actors and the possible effects of these ideological changes over policy outcomes. Their explanation of economic policy change in the US clearly showed how ideas can play an important role in shaping institutional outcomes. In this respect, Odell (1979) identified a meaningful change in the perception of key policy makers in the US between mid-1960s and early 1970s. For instance, Henry H. Fowler served as the Secretary of Treasury in the Lyndon B. Johnson's Democratic government between 1965 and 1968. According to Odell (1979), Fowler brought the office the general belief that dollar devaluation would have detrimental economic consequences for the international monetary system. Fowler thought that the end of fixed exchange rates policy would lead to the neo-isolationist world similar to the interwar period. He was also generally more inclined to Keynesian type of government involvement into economic activity. However, in 1970, Republican president Nixon nominated John Connally as his second Secretary of Treasury followed by George P. Shultz. Both of

these secretaries were more inclined to restricted government in line with Friedman's monetarist policies. In short, According to Odell (1979), the changes in the belief systems of the key policy makers were as explanatory as the balance of payments concerns of the US officials. In this regard, Odell's account of policy change identified hoe ideas and belief systems can play an important role as the material factors.

Cerny (1993) also stressed that the ideological shift from the Keynesian embedded liberalism to neo-liberalism was one of the major reasons for the collapse of the Bretton Woods. In a similar vein, Helleiner (1994) argued that neo-liberal advocates favored a liberal international financial order and favored free floating exchange rate regimes. Helleiner's argument only pointed out how certain ideas can be utilized for the material purposes as experienced in the American case, where corporate business adopted monetarist ideas quickly. On the other hand, according to Helleiner (1994:12), many politicians adopted these monetarist ideas for the practical reason that they found increasingly difficult to continue with Keynesian embedded liberal policies in the 1970s and 1980s. Economic slowdown and instability of the 1970s further helped these new ideas to become prominent. In this sense, it is fair to stress again how and why ideas become prominent in certain contexts and how they are interlinked with material concerns.

In this light, the domestic coalition of New York bankers and large multinational industrial corporations has been argued as another major reason for the collapse of the Bretton Woods system. It had long been recognized that the international

financial community has a vested interest in convincing policy makers that intervention and strict regulation of finance would be counterproductive and damage the economy in the long run (Frieden, 1987: 113). Similarly multinational industrial corporations would more likely to support free floating exchange rate and devaluation of the US dollar to augment their investment opportunities and increase their competitiveness. As expected, the major political and institutional change came up with the end of Bretton Woods has served to the interests of financial community and multinational industrial corporations.

The 1973 change in the exchange rate regime was particularly influential for the finance. However, a cautious remark might be helpful to remember the fact that the international financial community had earlier developed new strategies even under the constraints of Glass-Steagall and Bretton Woods to circumvent restrictions. For instance, the Euromarkets emerged as the off-shore markets allowing transactions over the US dollar outside the US territories. These new markets enabled financiers to keep financial transaction out off the balance sheet and escape from regulations and capital controls. Interestingly, the successive government in the US supported the emergence of Euromarkets with the incentive to deal with dollar glut in the 1960s (D'Arista, 2009). Frieden (1987) also argued that allowing Euromarkets stemmed from the policymakers' conscious preference to postpone the conflict between domestic economic goals. Allowing these markets, they were aware of the fact that they allowed financiers to circumvent national regulations. On the other hand, resisting the pressures of the international financial community in the Congress would have been much harder to support the postwar monetary order and capital

order. The unintended consequences of this postponement of interest policy resulted with the expansion of a 'free-wheeling' international financial system of unprecedented size (1987: 80-1).

International monetary system has underwent major changes in the post-1973 period. The evident difference stemmed from the US policy choice over free-floating exchange rates.[12] The decision of the US to end the mandatory controls of Bretton Woods and allowing currencies to float freely meant other nations to follow this policy choice. Hence, the post-1973 period, although with inconsistencies and diverse economic policies of different governments, was generally a period where free-floating exchange regime was persistent. Based on this fundamental change on the side of the US over policy options and the governing institutions, Helleiner (1994) questions why the US as the postwar hegemon shifted the policy paradigm and implemented free-floating exchange regime. Indeed, that question partly overlaps with the reasons for the collapse of Bretton Woods that I discussed and have similar causes. The first and obvious answer rests on the above discussion that fixed exchange rates were unsustainable for the US. Also, the ideological shift from Keynesian policies to monetarism was important as discussed. Yet, the monetary autonomy came with the free floating exchange rates should also be taken into account. As the Mundell-Fleming 'impossible trinity' predicts that, where financial markets are open and integrated, fixed exchange rate regime and monetary independence cannot be attained at the same time (Mundell, 1963; Broz and Frieden,

[12] Broz and Frieden (2001) state that there are basically two type of exchange rate policy and each nation has to decide whether to fix its currency or to float it freely. However, based on Frankel (1999), they also remind that there are at least nine existing regimes on a spectrum from a full float to a currency union.

2001). On this basis, Helleiner (1994) argues that the detrimental effects of Reagan administration's increased military spending and tax-cuts on fiscal deficit could be compensated with the inflows of foreign capital and financed growing external deficit. The ability to attract foreign capital stemmed from the continuing structural power of the US with its deep and liquid financial markets, as well as hegemonic position in the governance of global economy. Thus, the shift to floating exchange rates led to a rise in financial flows, stimulated deregulation of domestic financial systems and increased volatility in the financial architecture (Cerny, 1993). Accordingly, the following part will focus on the regulatory changes in the US and examines how financial system adapted itself through new environment and incentives with deregulatory reforms and legal changes.

This part discussed how interwar years shaped the preferences of actors on the point that speculative financial activities and highly flexible exchange rates disrupt international trade and likely to create global economic crises. The postwar economic order, hence, have been institutionalized on the principle logic that financial activities should be restricted with capital controls and strict regulations. However, the financial community was able to circumvent these restrictions with the emergence of offshore markets located in London City. Much more importantly, they were successful in utilizing the ideological changes to serve their interests. The general change in the belief systems of policy makers from Keynesianism to monetarism was well justified by this community on the basis of practical economic problems of the 1970s. The new economic and monetary institutionalization served to the interests of this community. The shift to floating exchange rates led to a rise in

financial flows, stimulated deregulation of domestic financial systems and increased volatility in the financial architecture (Cerny, 1993). Therefore, the following part will focus on the regulatory changes in the US and examines how national financial operations and banking practices changed.

2.2. Deregulations in American Finance

The changes in the domestic preferences of certain key actors in the US resulted with a change in the international monetary system. The changes in the domestic preferences over finance also directly shaped the economic policies of the US in the direction for eliminating strict rules of banking. Furthermore, the changes in the international monetary system towards free-floating regimes expanded the volume of financial transactions and make financial deregulation and globalization more likely to emerge and consolidate itself through an institutional and legal setting. In short, the dynamic interaction of these two levels evidently showed itself in the emergence of deregulation of finance in the US.

The financial community played a critical role in the deregulatory transformation of finance in the post-1973 period. In the previous part, I summarized how their attempts to circumvent strict rules of narrow banking system culminated with the emergence of Euromarkets and the collapse of Bretton Woods. Furthermore, the financial community supported Republicans and like-minded Democrats through political campaign contribution and with other means to support neo-liberal and monetarist policies. The primary objective was to satisfy financial openness and

deregulation, alongside with tax-cuts and reduction in welfare spending. Last but not least, monetarist policies of Friedman and Hayek well served to the interests of the financial community.

The efforts of the financial community centered in New York resulted with the weakening of strict regulation and the disruption of narrow banking model. The previous banking model that strictly regulates financial operations was based on the Glass-Steagall Act of 1933. As I discussed in the previous part, the unfortunate experiences obtained in the Great Depression converged broader segments of society and political elites on the general suspicious attitude toward finance. This suspicion led to a design of a narrow banking model that was mainly institutionalized and legalized with the Glass-Steagall Act. The most important article of Glass-Steagall obliged to investment and commercial banks to be separated under Section 21 of the Act (Coleman, 1996; Wray, 2009). Legislators of the Act believed that one of the reasons of the market crash in 1929 was the banks perverse incentive to invest on their own stocks with the depositors' money. Hence, such a separation was necessary to reduce the risk for the depository institutions and to protect consumers from conflict of interest (Coleman, 1996). Section 16 of the Act also restricted banks that belong to the Federal Reserve System underwriting securities and equities (ibid). In other words, the Glass-Steagall Act of 1933 broadly defined the confines of banking activities in the US since the 1930s.

The Glass-Stegall Act of 1933 and the narrow banking model, hence, remained as the major obstacle that New York bankers had to overcome throughout the postwar

years. Pressures of globalization, increasing competition in the financial domain with the emergence of London-based Euromarkets and the end of Bretton Woods strengthened financial community to abolish the rules of narrow banking model in the US. Especially, 1980s and 1990s witnessed the major changes in the regulatory framework of the banking activity. These changes targeted to remove the geographical segmentation of Glass-Steagall and eliminate or weaken the regulatory framework to allow new practices, operations and use of new financial instruments for the bankers. As such, role of the state in regulating and supervising has weakened. Instead, private actors and their interests became the primary beneficiaries of financial deregulation and globalization. Much more importantly, Underhill and Zhang (2008) observed that financial globalization rendered regulators more dependent on market interests and strengthened private actors to shape and set rules, which undermines the establishment of an accountable and legitimate financial order. Self-regulation and the withdrawal of state from regulating financial activities became the new doctrine of these financial communities.

Under the increasing influence of these financiers, serious changes in the legal and institutional realm occurred with major impacts on finance over the course of last three decades. In the following, a brief summary of the legal changes will be introduced within the realm of financial activities. As I pointed out above, these changes both facilitated geographical de-segmentation and eliminated strict barriers over financial operations. These changes also provided a legal and institutional framework for the increasing capability of private actors to implement self-regulatory policies instead of government regulation. The 1980s and 1990s witnessed

the partial elimination of Glass-Steagall Act and New Deal reforms on finance in the US. In 1999, The Gramm-Leach-Billey Act of 1999 repealed Glass-Steagall, heralding the new era of unlimited finance.

The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 was the first comprehensive legal change that partially removed restrictions of Glass-Steagall. The DIDMCA eliminated interest rate ceilings for deposits and partially eliminated state imposed usury ceilings. Also, the Act increased the power of commercial banks by increasing the deposit insurance limit (Coleman, 1996; Tregenna, 2009). For long time, the US were able to impose upper bound for interest rates and used this practice as a monetary policy both to balance international pressures and sustain home-ownership program and other social policies. However, during the 1960s, with the effect of Viet Nam War and tight monetary policy, corporate borrowers started to turn back from commercial banks and find loans from commercial paper market and off-shore markets. The traditional commercial banks were not able to respond to these financial and economic pressures and they started to lose their market share permanently since late 1960s. The DIDMCA were legislated under the strong Congressional pressure of commercial banks intending to involve to new financial practices and remove strict Glass-Steagall regulatory practices. Nevertheless, even after the DIDMCA, the balance sheets of thrifts continued to worse off while the money market mutual funds grew in an increasing manner (Coleman, 1996). The Congress responded again in 1982 with the Garn-St. Germain Depository Institutions Act. This new act allowed banks to purchase failed

banks and thrifts across state lines, as well as removed restrictions for real state lending and loans to single borrowers.

In line with the removal of barriers for commercial banking; the new legislatures, Treasury and the court rulings supported the geographical de-segmentation and concentration of banking in the US. Coleman (1996) argues that Treasury was one of the main supporters of interstate banking and welcomed the legal changes during the 1980s and 1990s. Major court rulings also supported this development. For instance, the case of 'Independent Insurance Agents of America vs. Ludwig' in 1993 allowed national banks to sell insurance from small towns, stimulating the trend toward conglomeration. All of these rulings toward geographical dispersion had been legislated in 1994 with Riegle-Neal Community Development and Financial modernization Act. This new act authorized interstate banking and branching, permitted interstate acquisitions and allowed merging across states. Tregenna (2009) empirically shows that these legal changes throughout the 1980s and 1990s lead to a continuous drop in the number of banks due a number of bank failures, as well as through mergers and acquisitions.

The major rupture with the New Deal narrow banking model came up with the repeal of Glass-Steagall Act in 1999 (Kregel, 2009). The Gramm-Leach-Billey Act of 1999 -also known as Financial Services Modernization Act- fundamentally changed banking practices and allowed greater autonomy to financial operations (Wray, 2009). This new act allowed different type of financial institutions to merge or affiliate with each other. As such, restrictions on conglomeration and concentration

were totally eliminated. In this manner, specific provisions were legislated for banking-holding companies to act as financial holding companies. Furthermore, the previous regulations on merging and acquisition of diverse financial institutions were lifted as well. Last but not least, national banks were also allowed to engage in new financial activities and underwrite diverse bonds (Tregenna, 2009). Letting new financial practices and merging commercial and investment banks –as well as other financial institutions- encouraged the extremes usage of securitization and high leverage, which were introduced as the magical financial instruments.

These deregulation banking sector were further supported by the securities market liberalization and the promotion of self-regulation. Commercial banks were also permitted to operate in securities markets. Indeed, the pattern of lifting tight regulations had already been evident since late 1960s. These commercial banks obtained the right to underwrite and deal in some municipal bonds, public retail brokerage and dealing in commercial papers (Coleman, 1996). Accordingly, market deregulation in securities entitled self-regulatory organizations with the legal mandate to develop, apply and enforce norms based on a formal delegation of authority by the government. Similar to Underhill and Zhang's (2008) analysis of Bank of International Settlements (BIS) and International organization of Securities Commission (IOSCO), national self-regulatory institutions, as well, endowed with specific rights and private actors were allowed to shape the agenda of financial governance.

These regulatory changes altered the dynamics of finance in the US. Based on Tregenna (2009: 611-3), I have already stated that the number of banks in the US drop dramatically due to removal of geographical barriers in the US banking laws. Removal of interstate banking restrictions led to the concentration of the financial activities and encourages conglomeration. For instance, Wray (2009) reports that while in 1990 ten largest financial institutions had 10% of the market share for financial activities, now [2009] it is 50%. He reports that with the changes in the regulatory framework, the number of mergers and acquisitions increased significantly. The financial community obviously supported and welcomed these regulatory changes. They justified these regulatory changes and concentration of financial activities on the grounds of increasing competitiveness, globalization of financial activities and foreign pressure. However, Tregenna indicates that profits of financial institutions significantly increased during the same period. Similarly, the wages and bonuses of top managers rose dramatically. For this reason, Crotty (2008) questioned why if financial competition is intense, financial firm profits are so high. Both Tregenna (2009) and Crotty (2008) argued that the profits that financial institutions enjoyed during this period were based on shaky grounds of new and highly risky derivative instruments, and the profits were not used to bolster the capital base. In other words, changing regulations and legal limitations created perverse incentives for the financial sector. These regulatory changes enabled and stimulated financiers to take more risks and encouraged investment of new derivative instruments with high leverage.

The brief overview of the regulatory changes in the US showed that legal and institutional changes allowed financiers to operate freely in conducting their operations. The deregulation of finance resulted with the concentration and conglomeration of financial activity, increasing number of mergers and acquisitions, as well a general decline in the number of minor banks. In parallel to these developments, the merging of investment and commercial banks allowed financial operators to innovate new instruments to escape from capital adequacy ratios and to make larger profits. The next section will, therefore, discuss how these regulatory changes provided the basis of the emergence of a new financial architecture.

2.3. The New Financial Architecture

Observers of international economy pointed out the changing nature of financial practices in the last three decades. One of the major changes was the shift in the international monetary order toward flexible exchange rates and elimination of capital controls, which stimulated cross-border financial activity. The other was the relaxation of regulation of financial activity and greater freedom of financiers in their operations. On this basis, Susan Strange (1986, 1998) identified new financial system as a 'global casino' associated with more volatility, more uncertainty and more anxiety. To Strange, such a transformation was not acceptable on the social and political bases that ordinary people never been asked if they want to gamble their jobs, savings and income (1998:3). Similarly, the recent analysis of the current crisis focused on the problematic nature of financial systems. Crotty (2009:563) stated that "although problems in the US sub-prime mortgage market triggered the current

financial crisis, its deep cause on the financial side is to be found in the flawed institutions and practices of the current financial regime". To Crotty, this new financial architecture refers to deregulation of financial activities, innovation of new and highly-risky financial operations and instruments, and wider integration of national economies. While inadequate regulation created perverse incentives on the part of financial operators and made government less able to control what was happening in the financial realm, new instruments with their high leverage made financial systems more volatile and prone to crises. Evidently, the integration of national markets both boosted the volume of financial activity and make contagious spread of crises more likely.

Based on these general observations, in this part, I will discuss the changing structure of the finance with reference to extreme risk-taking and financial derivatives. Then, I will present a heterodox critique of the new financial architecture emphasizing how perverse incentives, higher leverage and lack of regulation brought a new financial order that is prone to crises. Lastly, I will discuss briefly the distributional aspects of financial transformation.

The lax regulations allowed financial community to operate freely and create new instruments for financial activities. Unlike the New Deal era, financial community was not restricted with interest rate ceilings, or they had to operate either as a commercial or investment bank. Much more importantly, as Kregel (2009: 656-9) puts forth, the borrowing and lending practices were fundamentally different in banking operations. Under the New Deal banking system, loan officers would

originate loans as new deposits and they have to turn reserve desk to find deposits or interbank lending to reserve them at the capital adequacy ratios. However, in the new financial architecture, or in the world of 'securitized assets', the loans are sold or packaged for trusts and to other securities institutions without considering capital adequacy ratios, only relying on new derivative instruments to hedge the risk.

The new financial system was based on a high ratio of systemic leverage and moving assets off their books to escape from capital adequacy ratios. Due to this extreme-risk taking practices, leverage rose dramatically from 10 to 12 traditional banking practices to investment banking ratios of 30 and to extreme hedge fund ratios of 300 (Wray, 2009:820). It was evident that higher the leverage means more the risk is taken. Indeed, risk was increasing with the higher ratios of leverage, but it was believed that securitization and credit default swaps will distribute the risk. However, these new financial instruments could only obscure extreme risk-taking for a while. Leijonhufvud (2009) argues that the actors in the financial system were aware of the extreme risk-taking. However, competition was so intense that it makes impossible to opt out of the process. The perverse incentives in the system encouraged financial actors to join the benefits of extremely risky business. As the Financial Times reported in 2007, "when the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing". As rational actors, financial players willingly joined the augmenting bubble.

The bubble-like dynamics of new financial instruments became evident with the crisis of the sub-prime mortgage market. The virtual cycle emerged with a causal mechanism of easy credit options, rising house prices and further leverage. As the new financial instruments were introduced, credit in general became much cheaper and largely available. The ordinary Americans used this option to compensate their household consumption and buying new assets. With an artificial rise in the demand of assets, the prices continuously increased and encouraged financiers to innovate new financial instruments with higher leverage ratios. The higher leverage further made credit even more available and cheaper (Wray, 2009). It was highly profitable for the financial community to expand the credit basis and reach broader segments of the society. Nevertheless, the prices for housing market were not able to rise permanently. However, no one dared to step back and enjoyed profits, benefits and fees.

The flawed nature of the new financial architecture have been criticized by non-mainstream/heterodox economists and political scientist on the bases that perverse incentives in the system encouraged risky behavior and make system prone to crises (Crotty, 2009). One of the central dimensions of the perverse incentives stemmed from the changing relationship between borrower and lender. In the traditional banking system, bank as lender should carefully observe the borrower and evaluate whether the borrower will be able pay back the credit or not. However, in the new financial system, the main incentive of borrowers was to originate and distribute credit. To the extent that the risk will be packaged and redistributed, with the backing of securitization and default swaps, they were not interested with the borrowers'

ability to pay the credit back. The real profits, instead, came with the fee income that is obtained in the packaging and distribution of loans in every transaction. Similarly, top managers of financial firms were granted with bonuses and extra payment for their 'successful' operations. In a sense, to the extent that managers followed risky strategies, they were awarded with the extra payments. Thus, managers followed a rational strategy to take excessive risks even if they were able to comprehend that the expanding bubble will crash in the near future.

Another major drawback of the new financial system was lack of regulation and the resulting opacity and complexity of new financial instruments. Neither necessary regulation existed nor the new financial techniques and the associated risks were understood adequately. Based on anecdotal evidences, it has been frequently noted that neither top management of financial institutions nor the ones who are in charge of regulating financial operations were able to comprehend the complex models of new financial instruments (Wray, 2009). Apparently, systemic and institutional risk in the financial operations could not be evaluated successfully. In the words of Crotty (2009:565), "innovation exceeded comprehension". In parallel to the inadequate understanding of these new financial instruments, regulators allowed financial institutions to measure their own risk and encouraged self-regulation (Crotty, 2009; Underhill and Zhang, 2008). However, giant financial conglomerates were too large and complex to be regulated by the insiders or outsiders. Also, the harsh competition over increasing leverage made it impossible for financial actors to stay outside of the process. All of these factors brought an ever expanding bubble distributing enormous benefits to the ones who joined.

The new financial architecture had also distributional implications. The long term problems of rising inequality and stagnant real wages were compounded with the transformation of financial architecture. On the one hand, financial deregulation, innovation and globalization deteriorated the income distribution with larger benefits to top income shareholders and professional top managers. Also, the financial volatility and its effects over real economy resulted with the loss of jobs and industrial production. But on the other hand, cheap and available credit allowed US households to compensate stagnant wages, deteriorating income and decreasing life standards with more borrowing. In a sense, financial innovation enabled individuals to borrow easily to sustain their previous life standards.

2.4. Major Findings

The new financial architecture seems to have a large impact on the global governance of the global economy and finance. Particularly, the US has experienced the impacts of unprecedented financial expansion and innovation with the recent economic crisis. In order to assess these impacts and to have a greater understanding of the dynamics in the US economy, the next chapter will focus on the distributional aspects and evaluate how new financial system affected the broader patterns in the US economy. Finance, as the previous paragraph predicts, seems to operate in the way to compensate long term stagnant wages and economic inequality by providing easy and cheap borrowing. Before discussing these issues in detail in the third chapter, in the following, I will briefly summarize the main findings of this chapter.

This chapter has been written with historical institutionalist influences and paid particular attention to the evolution of institutions within a dynamic relationship between actors, interests and ideologies. Examining the broader changes in the international monetary system, deregulation of finance and the new dynamics of financial structure; the central objective of the chapter was not only to point out how institutions were shaped by actors in line with their interests and ideas. I also paid attention how certain institutions constrained the behavior of actors and how these actors were able to circumvent these limits or how they were able to establish new institutions to overcome these obstacles. The historical evidence how international financiers circumvent strict rules of Bretton Woods and narrow banking model was a great example to such a relationship between institutions and actors. Furthermore, I detected how national and international levels operated in conjunction with each other in the case of banking regulation and international monetary order. The US case was particularly relevant to my argument in the sense that the US as the global hegemonic power was effective in shaping global economic policies. I analyzed how Bretton Woods emerged within the confines of the Great Depression experience in the US and the emerging Keynesian paradigm. Similarly, the domestic decision of the US to end the Bretton Woods order had a particular impact on the global monetary governance, as well as national regulation of financial activities among many nation states.

The analysis of the international monetary systems indicated that the type of exchange rate regimes and level of capital freedom affects particular financial

activities and the associated regulations within the national domain. Bretton Woods system was characterized with fixed exchange rates and capital controls to secure international trade. Finance was severely restricted in this international order to prevent possible negative effect over international trading. Thus, the playing ground was mostly restricted for the international financial community with capital controls, as well as national financial activities was confined within the narrow banking model of New Deal reforms and Glass-Steagall Act of 1933. However, throughout the 1960s and 1970s, the financial community was effective in circumventing national and international limitations with off-shore market operations. They also utilized the power of monetarist ideas to end Bretton Woods order and effectively justified their stance on the basis that the previous system lead to economic slowdown in the 1970s. Pragmatic policy makers increasingly adopted these new ideas and practices because it became harder to sustain Keynesian policies with the economic failure of 1970s and strong pressure for corporate business.

Most of the regulatory changes in the US financial system occurred with the end of Bretton Woods system. A number of acts, court rulings and institutional changes targeted to change the tight Glass-Steagall provisions and instead replaced a lax regulatory framework. Two major aspects of the regulatory change were the geographical de-segmentation of banking activity and the elimination of tight rules in financial operations. Large conglomerations dominated the financial market with the ability to serve in broader sections of the US and able to act as both investment and commercial banks.

As a result of the regulatory changes, the nature of financial activities dramatically changed in the last three decades. The most fundamental change occurred in the credit creating mechanism. Instead of keeping adequate capital ratios and insisting on the reliance of borrowing customer, the new 'originate and distribute' system operated on the basis of higher leverage and fee income. Financial firms no longer checked the reliability of the borrower, but focused on the fee income gained after every transaction. Such an incentive structure encouraged extreme risk taking and stimulated even more leverage. Even though the top managers were not exactly aware of the risk they took, they insisted to engage these activities within the perverse incentive structure of fee incomes and bonuses. Inadequate regulations, as well, were not able to check and control the complexity and opacity of these new financial instruments. The result was the financial boom that incorporated broader segments of the society.

CHAPTER 3

EMPIRICAL TRENDS IN THE US ECONOMY: ECONOMIC INEQUALITY, CONSUMERISM AND FINANCIALIZATION

> "…it might at first seem needless to say that before social facts be 'explained', it is advisable to ensure that they actually are facts. Yet, in science as in everyday life, explanations are provided for things that never were"
>
> Merton (1959) quoted in Krippner (2005: 174)

The previous chapter showed the centrality of the United States (US) in the governance of the world economy and examined how policy-makers, financiers and popular demands in the US shaped the architecture of international finance throughout the 20th century. As such, this previous chapter discussed how US established its hegemony in the post –war era by consolidating the US dollar as the reserve currency for international trade and financial transactions. In parallel to the previous chapter, this part focuses on the dynamics of domestic US economy and aims to reveal the broader trends with particular emphasis on the rise of productivity, stagnant real wages, economic inequality, consumption patterns and increasing debt levels. Also, this part elaborates on the main economic indicators –e.g. economic

growth, inflation, unemployment and government balance and savings/investment- with reference to other major industrialized countries and the historical evolution of the US economy. As such, this chapter intends to present major facts regarding the US economy in order to provide an empirical base for the rest of the thesis and the arguments supported.

This chapter, firstly, embeds the US economy in a comparison of G-7 countries to demonstrate the magnitude of the economy, as well as to better identify the positive and negative aspects of the US economy for the subsequent analysis. The second part of the chapter analyzes the major continuities and ruptures in the US economy with particular emphasis on income equality and social dynamics. On this empirical basis, this chapter then, aims to build a causal mechanism to explain how historically constructed standard of living, consumption and indebtedness are interlinked in the US context. Hence, this chapter links how financialization and increasing debt in the US economy compensates long-run stagnant wages and enables households to protect their standard of living.

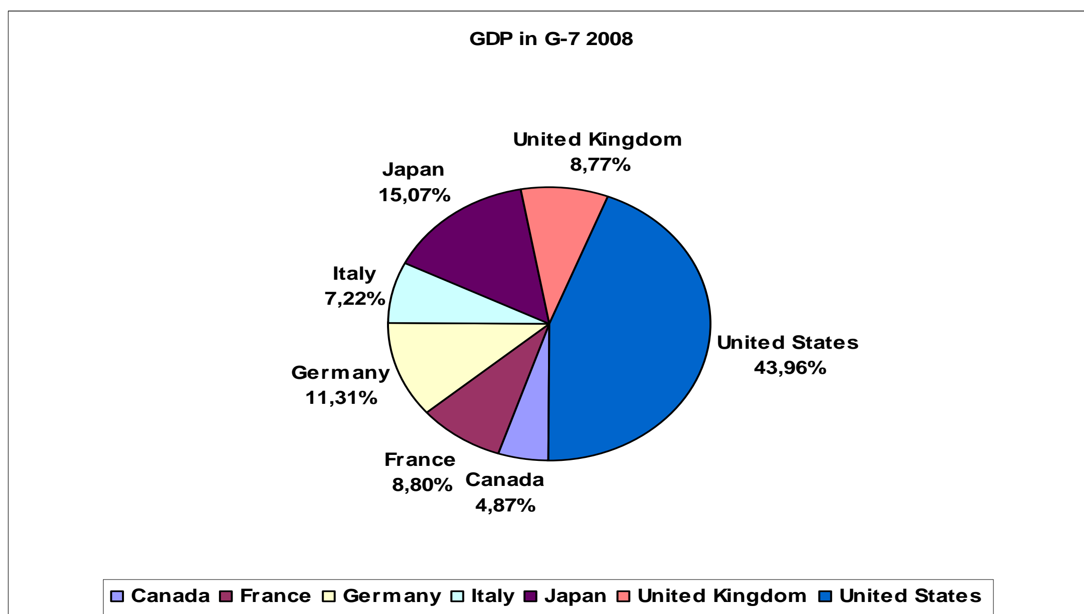
3.1. US Economy in Comparative Perspective

The US economy is the largest national economy in the world with a GDP of $ 14.2 trillion in 2008.[13] With its huge magnitude, the US economy constitutes almost one-quarter of all economic activity in the world. Even among the major industrialized

[13] IMF World Economic Outlook Database April 2009.

countries[14], the US are by far the leader in terms of economic size. Figure 3.1 clearly indicates that the size of the US economy have incomparably huge. For example, the second largest economy, the Japanese economy, have only one-third, and the German economy is only one-forth of the size of US economy. For this reason, as I argued in chapter two, the US has an undisputable impact on the governance of world economy and its governing institutions.

Figure 3.1 Share of Economic Magnitude Among G-7



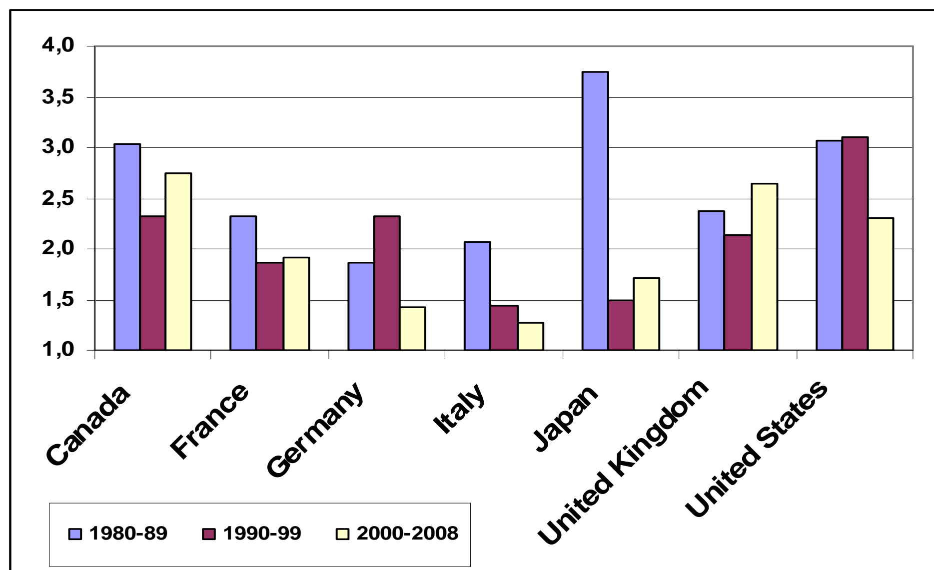
Source: IMF World Economic Outlook Database April 2009

The US economy has maintained stable growth, low unemployment and low inflation for many decades. Compared with G-7 countries, it is evident that the US economy performed better than other six countries in the last three decades. Figure

[14] Here I use G-7 countries for comparison.

3.2 shows the economic growth (change in GDP) for the last three decades.[15] The figure demonstrates that while the Japan was the outperformer of the 1980s, it stagnated in the 1990s and 2000s. The three continental major economies -France, Germany and Italy- could not maintained high growth rates as Canada and United Kingdom. The United States, on the other hand, performed well in comparison to other six countries. The US were the second behind Japan in the 1980s, first in the 1990s, and third in the last decade.[16] For three decades, US performed best among G-7 with an average growth rate of 2,83 % followed by Canada and the United Kingdom.

Figure 3.2 Economic Growth in G-7 For the Last Three Decades



Source: IMF World Economic Outlook Database April 2009

[15] The data are obtained by the IMF World Economic Outlook Data and decade growth data is calculated by the author taking simple averages of the annual data.
[16] The respective growth rates fort he US are 3,1; 3,1; 2,3 (IMF).

Table 3.1 Unemployment and Inflation Rate in G-7

	Unemployment 1980-2008	Inflation rate 1980-2008
Canada	8,45	3,69
France	9,24	3,8
Germany	7,18	2,37
Italy	8,68	6,09
Japan	3,2	1,22
United Kingdom	7,66	4,07
United States	5,91	3,82

Source: IMF World Economic Outlook Database April 2009

Similarly, the US economy performed well in the post-1980 period in terms of keeping unemployment and inflation rate low in order to create incentives for further investment and providing job opportunities for the population. The table shows that the US economy has the lowest unemployment rate after Japan. On the inflation front, the US has an average inflation around 3-4 per cent for three decades, which is similar to other G-7 counterparts. Japan has the lowest inflation rate of 1,22 %. However, it is evident that very low inflation rates do not necessarily indicate the health of economy. In contrast, it may signal recession as experienced in Japan in the 1990s, with a serious decline in demand for consumer goods and growth rates. In short, in the post-1980s period, it seems that the US economy have performed well in three major indicators of economic well-being –economic growth, unemployment and inflation.

Even though the major macroeconomic indicators present a nice picture of the US economy, a cautious remark would be helpful in the sense that some other less available or less analyzed indicators show how the growth might be uneven and likely to yield different outcomes. The comparative analysis below, first of all, indicates that income had been distributed unequally in the US for many decades in contrast to other G-7 countries. Table 3.2 shows the Gini coefficients[17] of G-7 countries. It is evident that the US has the worst distribution of income among G-7 countries. The US has also the lowest figures for gross domestic savings and investment. While the US citizens, corporations and government could save only 13 % of GDP, 17 % of national resources were devoted to investment. On this empirical basis, it is apparent that the US cannot save and devote its domestic savings to investment. Rather, even such a low level of investment has been maintained with the help of capital inflows and the role of US dollar as reserve currency.

Table 3.2 Alternative Indicators

	Gini Coefficient	Savings 2008	Investment 2008	CAB 2008	Government Balance 2008	Government Debt 2008
Canada	0,326	22,47	23,362	-0,892	0,1	66,243
France	0,327	20,06	22,416	-2,357	-2,764	64,589
Germany	0,283	23,34	18,121	5,219	-0,676	62,373
Italy	0,36	19,548	21,944	-2,396	-2,477	103,591
Japan	0,249	28,101	24,134	3,972	-3,364	197,508
United Kingdom	0,36	13,617	18,465	-4,848	-3,057	43,459

[17] Gini coefficient is a commonly used indicator of income inequality. The index is a ratio between 0 and 1. The higher the Gini value is the less the society is equal in economic terms. Where 0 equals perfect inequality, 1 refers to perfect inequality.

United States	0,408	13,027	17,357	-4,33	-4,468	63,248

Source: The Gini coefficients are taken from UNDP Human Development Report 2007/2008. Other data were compiled from IMF World Economic Outlook Database April 2009.

The comparative data on G-7 countries also reveals that the US economy have serious economic imbalances. In parallel to the savings-investment disparity, current account deficit[18] in the US has considerably increased in the last three decades. The data shows that the US has the biggest current account deficit in terms of its GDP after United Kingdom. Unlike the pattern in the US and UK, Germany and Japan -as the major exporter countries- had current account surpluses in 2008

On the government side, the US has similar imbalances. The long military expenditures spent for the war campaigns in Afghanistan and Iraq has deteriorated government balances. The 2008 budget gave deficit of 4.5% in terms of GDP. As can be seen from the table, this is the worst amount among G-7 countries. On the government net deficit, the US Treasury have a deficit of 63% in terms of its GDP. However, it should be noted that these data do not consist of the negative effects of financial packages on the government budget. The expansionary monetary and fiscal policy to overcome the economic crisis will create a burden on the budget and government deficit.

[18] Current account balance is composed of three main elements: balance on goods (exports minus imports), balance on services and net transfer (savings minus investments). The US economy has been experiencing deficit of goods and investment. The deficit has been compensated by financial inflows in the balance of payment.

The comparative analysis yielded some productive results for our discussion of the US economy: Even though the major indicators of the economy seem to be healthy, an analysis that digs beneath the surface indicated that the income of distribution is unequal in the American society. Furthermore, there are serious major imbalances of savings/investment, current account and government/budget deficits that can be hardly sustained without major economic shocks. In the light of this section, the following part will elaborate on the historical evolution of the economic dynamics in the US with a major focus on income inequality, stagnant wages, high level of consumption and low savings rate.

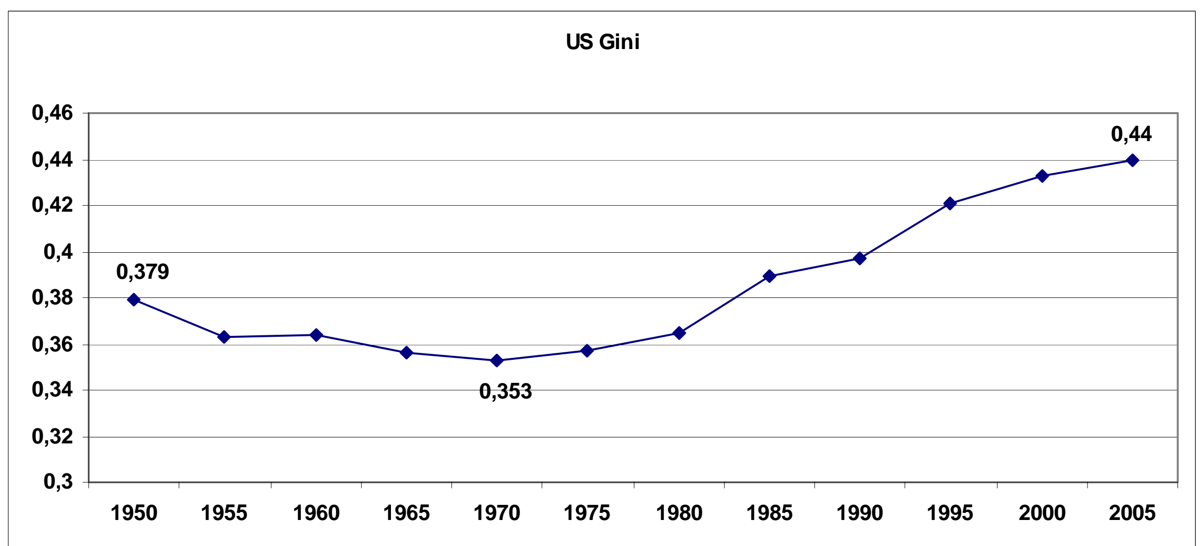
3.2. Historical Perspective on Socio-Economic Dynamics

In 2007, at the dawn of the crisis, the major economic indicators such as economic growth, unemployment and inflation seemed healthy and conducive to optimism for the future performance of the US economy. However, the sudden contagious liquidity crisis in mid-2007 seriously affected the financial institutions in the US and the overall performance of the economy. The crisis deepened in 2008 with the bankruptcy of major financial institutions in the US and with negative effects on the real sector: decline in production, employment and demand. This crisis, hence, once more indicated the structural problems of the US economy and how major imbalances in the US are unsustainable. It is evident that the crisis emerged out of the crunch in credit markets. The deregulated financial markets, financial derivates and policy measures were the major causes of the crisis (see chapter 2). Yet, fewer studies focused on the socio-economic dynamics of the expansion of credit markets.

This part discusses the root causes of this crisis with reference to rising income inequality and stagnant real wages in the American society with a historical perspective.

Critical American economists pointed out the income inequality as one of the major social problems in American society and discussed how unequal income distribution formed the basis of major imbalances in credit markets (Paul Krugman 2004; Robert Reich 2008; Berry Eichengreen, 2008). What these scholars observed and emphasized is the simple fact that *the distribution of income in the American society deteriorated in the post-1973 period. While the post war period (1945-73) were the years of rising equality in the society, the trend reversed after 1973 and accelerated in the 1980s as evidenced by the historical Gini coefficients in the US and qualitative research on the issue (Figure 3.3).*

Figure 3.3 US Gini Coefficient in Historical Perspective



Source: Compiled and illustrated from the US Census Data

The historical Gini coefficient datum shows the broader arc of equality and inequality in the American society. The equalizing features had been dominant in the post-war years as the Gini datum represents. As expected, the datum points out the general trend but do not reveal the underlying reasons behind them. Hence, it is necessary to extend the scope of analysis to structural changes and political aspects in the US in order to see why American society has progressed alongside the income equality between 1945 and 1973. Economic historians focused on two major changes in the US economy in this period: one is the structural changes in the economy culminating with efficient industrialization, job opportunities for unqualified labor and blue-collar dominated job market constituting the middle-class in the US. The other explanation focuses on the Keynesian policies of the Democrat governments of the 1960s and equalizing impacts of emerging welfare state arrangements such as Medicare (Levy, 1998; Kemp, 1990; Vatter and Walker; 1996).

The post-war American economy had been characterized with the declining importance of agricultural production, transformation to a more technologically-driven industrialization, and the rise of middle-class mostly occupied with blue-collar workers. Levy (1998) argues that the labor force that was occupied with agricultural production declined in this period significantly. The number of farmers dropped from 7 to 4 million from 1947 to 1959 (1998: 29). However, this labor force could easily migrate to the urban areas and had no difficulty in finding jobs in the augmenting industrial sector. Similarly, American industry became much more productive and was able to transform itself to the manufacturing of value-added products. For example, during the same period while steel production declined the aircraft and

automobile industry experienced significant rise (Levy, 1998). Such a transformation not only enabled corporations to make larger profits but also to make them much more willing to make new investment. Enlarging economy, thus, needed much more labor force to take part in industrial production. Hence, unqualified blue-collar workers occupied in industrial sector formed the major portion of labor force in the post-war US economy. The same blue-collar workers and their families, for this reason, constituted the middle-class in American society which for long time identified as the backbone of society (Krugman, 2004).

During the post-war years, the industrial transformation and rising importance of blue-collar workers in the US economy alongside with the prevalence of middle-class households in American society reflected itself with a significant rise in life standards and income. By 1947, the median family income was of $19.500. However, this median amount increased to $26.500 and $40.400 in 1959 and 1973, respectively (Levy, 1998).[19] Rise in the family incomes stimulated household consumption and demand for items and utilities. The significant rise in household consumption was also a repercussion of previous recession. In this regard, Levy (1998) claims that the rise of income enabled American families to compensate the post-1929 economic recession and its repercussions on their life standards. Typical American families consumed more automobiles, were able to buy their homes (also second home) and acquired home utilities such as television and vacuum cleaners. The 1950s and 1960s, in a sense, were the years that both made typical families much more prosperous and set the standards of living for middle-classes. In short,

[19] Please note that Levy's calculations are based on 1997-chained dollar prices.

changes in the structure of the economy increased the income of middle-class families and blue-collar workers enabling them to maintain a high standard of living. As such, income inequality in the US decreased throughout the 1960s and 1970s.

Economic policies pursued by the Democrat governments in the 1960s were in favor of more income equality. These policies, in a sense, complemented the structural changes in the economy and helped to increase economic equality through permanent increases in the real wages and expansion of welfare benefits for the lower segments of the society. Keynesian activism of John F. Kennedy and Lyndon Johnson led to significant productivity increases in the 1960s. The US economy experienced more than 3% productivity increases throughout the presidency of Kennedy and Johnson. Furthermore, increase in the productivity provided real wages to grow and make blue-collar workers and middle-class households increase their income and life standards (Levy: 32). In line with the increases in the incomes, benefits provided by government programs increased in this period. Cox and Skidmore-Hess states that in the mid-1960s, "Democratic administration… moved toward the implementation of long frustrated goals of expanding the social welfare system. In 1964, … Congress voted in favor of a regressive increase in pay-roll taxes to fund the Medicare program. The next Congress elected in the 1964 landslide enacted a broad array of programs in health, education, housing and welfare under the Johnsonian auspices of the Great Society and War on Poverty" (1999: 118). Both the increases in the real wages, increasing tax rates for corporate profits and newly introduced and enhanced welfare programs helped to smooth the inequality of Gilded Age and made post-war American society much more equal.

The seventies came up with turbulence in the US economy. In 1971, US President Richard Nixon decided to devaluate the US dollar, which effectively ended the Bretton Woods Agreement. In early 1970s, dollar was artificially expensive and competition was intense. In such an environment, the post-war policy of maintaining further economic integration with the help of Bretton Woods under the hegemony of the US started to attract serious domestic opposition. The US found it difficult to manage dollar-based international financial system (Frieden, 1987). The volatility of the currencies and financial markets increased after the collapse of Bretton Woods. Furthermore, the supply shock in oil led by the Organization of Petroleum Exporting Countries (OPEC) in 1973 and 1978-79 caused a sharp increase in energy prices. OPEC oil crisis increased production costs, thus, led corporate profits to decline and inflation to rise. The US economy had to deal with inflation, unemployment and stagnation in the 1970s. Uncertainty and decreasing rate of profits caused corporations to hold back their support from Keynesian compromise or embedded liberalism of 1960s and 1970s (Cox and Skidmore-Hess, 1999; Ruggie, 1982). Keynesian economic principles and its policy implications in the US has become a matter of increasing debate and criticism. Monetarist insights with focus on tight monetary policy and market fundamentalism have been gaining much more credibility in the 1970s. Increasing opposition to Keynesian compromise reflected itself in the presidential campaign of Ronald Reagan. Cox and Skidmore-Hess argues that the support of multinational corporate elites to the Reagan candidacy reflected a business attitude to roll back from the welfare state and its arrangements (1999: 161). Business concerns for declining profits and interests of finance capital prevailed.

Reagan's presidency witnessed a major U-turn from the previous economic policies of post-war years. In contrast to Keynesian features of the previous period, Reagan adhered to monetarism and market fundamentalism emphasizing the supply-side arguments in favor of increasing efficiency through tax cuts and reduction of government expenditures. Reagan's economic policies had three objectives: massive tax cuts for the wealthy and for corporations in order to stimulate investment and economic growth, reduce social spending to reduce budget deficit and apply tight monetary policy to control inflation. As expected, these policies favored the wealthy Americans and ignored the rest of the population. As the Figure 3.3 shows, the income gap between poor and the affluent widened during the Regan's presidency. The reasons for the rising gap were again twofold: political decisions and structural changes in the economy.

Economists who argue that rising inequality stemmed from the changes in the economic structure emphasized the importance of service sector in contrast to the declining role of industry in the US (Levy, 1998; Lawrence, 2007). To them, most of the changes in the income distribution were due to the transformation of the US economy from an industrial economy dominated with unqualified blue-collar workers to an service based and information economy that requires high quality education and skills to adapt technological changes. In 1980s, the gap between the earnings of those with college education and those with high school education increased (Levy: 118). People responded to these changes trying to attend colleges and spending more on education. Nonetheless, within the 1980s, the backbone of the

middle-class American family characterized with blue-collar father and housewife with children started to collapse.

There were evident structural changes that had a direct impact on income inequality. Unlike the former group, many economists with a critical or heterodox stance argued that the deteriorating income equality in the US stemmed from particular political choices rather than mere changes in the economic structure. Paul Krugman (2004, 2007) stresses that the timing of political and economic change it was politics, and not economics, was taking the lead. The right-wing take-over with the presidency of Reagan represented small elite and their interest. He states that “the Republican Party chose to cater to the interests of that rising elite, perhaps because what elite lacked in numbers it made up for in the ability and willingness to make large campaign contributions” (2004: 5). The support from wealthy families and business community before the presidential campaign of Ronald Reagan and the policies implemented afterwards, therefore, particularly needs attention.

Having supported by the business community and the economic elites, Ronald Reagan was quick to implement a radical economic policy package. The first of three major economic policies was the massive tax cut for the wealthy and corporations. In its final version, the Economic Recovery Tax Act cut tax rates for business in half, dropping them from 33 % to 16 % overall, and reduced the corporate income tax share of federal tax revenues from 21.3 percent during the 1960s to 6.2 % during the 1980s (Cox and Skidmore-Hess, 1999: 169). The tax cuts were justified on the

grounds of Laffer curve[20] arguing that the existing US rates were so high that they discouraged significant investment and job creation. Lowering taxes would result in more investment, and the federal government would actually benefit from increased revenue. The expected positive effects of the Laffer curve are disputed, however. During the same period government revenues decreased and deficits increased. What was undisputed about the tax cuts have been the fact that the wealthiest 1% of the population saw dramatic improvements in their wealth and were the real beneficiaries of the Reagan tax cuts. The immense improvements in the wealth of the top 1% and moderate improvement of the top 20% of the population helped to amplify the unequal distribution of income and wealth in the American society.

The reduction in the government expenditures on social programs exacerbated the income inequality. The cuts in the social spending led erosion in the benefits of various means-tested programs targeting the low-income population. Cox and Skidmore-Hess reports that during the Reagan's presidency the funds devoted to the food stamps reduced 14%, child nutrition fund reduced 28% and Aid to Families with Dependent Children (AFDC) reduced 14% (1999: 170). All of these reductions in social spending directly affected the most vulnerable portion of the American society. Levy (1998: 49) notes that the percentage of GDP obtained by the lowest quintile decline to 4.6% in 1989 from 5.5% by 1973. Similarly, poverty rate increased from 11.1% to 12.8% between these years. Furthermore, concerted effort to weaken the position of organized labor further deteriorated middle and lower class

[20] Laffer curve used to illustrate that increasing tax rates do not necessarily produce more taxation revenue since investors will have no incentive to continue their investment with high tax rates. Laffer curve, thus, argues that lowering tax rates create incentive for further investment and increase ax revenue.

unskilled workers. Major changes in the Labor Law favored management over labor especially on issues of flexible employment and constraints on collective bargaining.

Another major economic policy of Republicans in the 1980s was the implementation of tight monetary policy to combat high inflation. Reagan administration viewed tight monetary policy as major policy tool to attract foreign capital to the US. Such a policy supported by the multinational firms and financiers led to a decline in inflation but created unemployment, hence, expanded the gap between rich and poor. Similarly, Reagan administration deregulated financial, electricity and telecommunications markets throughout the 1980s. Tight connections with the business community and vested interest underlying these deregulations have been discussed previously. Nonetheless, these regulations have been an integral part of Reganaomics and contributed negatively to income distribution in the American society.

The presidency of George H. W. Bush (1989-1993) followed the similar economic policies pursued in the Reagan era. Bush's efforts rather concentrated on military and foreign policy issues. However, such a military expansion augmented the fiscal deficit and could not resolve the recession of 1990s. The recovery came afterwards was only a "jobless recovery" and could not create new job opportunities for the vulnerable masses (Stiglitz, 2003: 33). The 13 years of Republican administrations had a catastrophic economic inheritance for the newly elected Democrat president Bill Clinton. The new president had to solve the problem of high unemployment rates and extreme budget deficit.

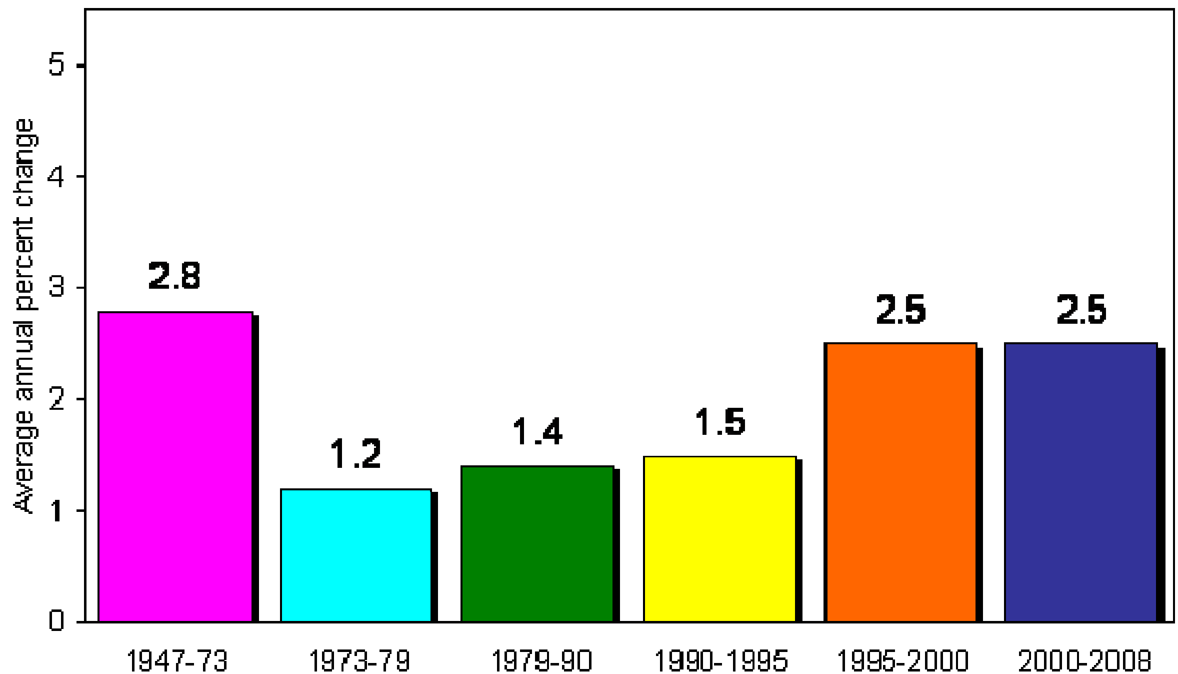
Clinton administration's first priority, then, had been reducing the government deficit (Stiglitz, 2003; Reich, 2008). However, reducing fiscal deficit meant for the Democrats to curb their social spending expenditures. According to Reich (2007), who served as the Secretary of Labor in Clinton's administration, "Clinton had been saddled with Reagan's profligacy. Reagan had borrowed from Clinton and Clinton was having to pay it". Fed president Alan Greenspan had also a direct role in reducing the deficit in extreme form before the election in 1996. According to Reich, "Greenspan's advice to Clinton came with an implied promise and threat: If Clinton cut the deficit, Greenspan would reduce interest rates and allow the economy to expand briskly…The choice was Clinton's but Greenspan held a gun at his head". The efforts of Clinton to improve Healthcare policy were impaired by the fiscal constraint, as well as the electoral victory of Republicans in the Congress after 1994.

Clinton managed to create new job opportunities for the larger segments of the society and reduce unemployment below 6%. At the same time, though the rich gained the largest share of gains, everyone seemed to be gaining. For the first time in a quarter century those at the bottom saw their incomes began to grow (Stiglitz: 6). However, the *roaring nineties* were also years of seeds of destruction were sown. The abolishment of Glass-Steagall Act, further deregulations in the electricity and telecommunication markets, Enron and dot.com scandals occurred during the Clinton administration. All of these scandals were result of the corrupt systemic features I corporate management, lax accounting and supervision and deregulation wrapped up with free market mantra –i.e. over-reliance on markets.

Bush W. Bush's administration witnessed a conservative turn back in American politics. The extensive tax cuts came with Bush administration with the similar supply-side economic principles favoring to stimulate investment. Unfortunately, government deficit have risen in the new Republican period due to these massive tax cuts, as well as increasing military spending as a result of new imperial/hegemonic expansion of American foreign policy. As expected, the economic dynamics in the early 21st century enlarged the income differences between rich and poor. Moreover, the finance-led growth and boom dynamics prevailed throughout the decade ending with the bursting of housing bubble and credit crunch in 2007-08.

The previous discussion briefly reviewed the history of economic inequality in the US with reference to structural changes and policy choices. The analysis indicated that while the post-wars years were the times when equalizing tendencies have been dominant in the US economy, the trend has shifted in the post-1973 period and inequality accelerated throughout the 1980s. Nonetheless, this is an inadequate depiction of the US economy. As stressed in the comparative analysis, the US economy recovered in the 1980s and gained significant economic growth through productivity increases. Even though the increase in the productivity by the 1980s and 1990s were not as high as the post-war years, nonetheless, *the productivity increased permanently in the US economy by the second half of the 20th century. The cumulative productivity increases after the 1970s to the first decade of 21st century reached almost 70 %.*

Figure 3.4 Productivity Increases in the United States

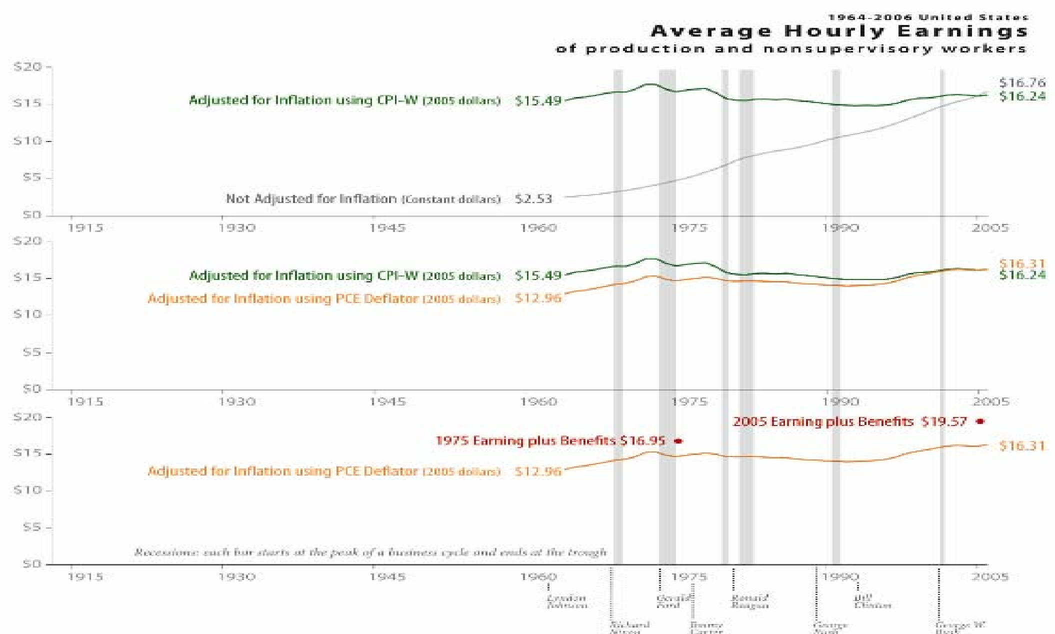


Source: The graph was taken from Bureau of Labor Statistics

Normally one would expect a similar increase in the real wages and income of typical American family. However, as discussed widely above, both the structural and political factors prevented income and new gains to benefit from the productivity increases. *During the same period (1973-2008) the real wages remained almost stagnant, which means that an average worker remained to earn the same amount (adjusted for inflation) in 2008 as he was in 1970s.* The figure 3.5 shows that average hourly earnings of production and non-supervisory workers (blue-collar workers) remained stagnant (even slightly lower) since the 1970s. This datum confirms and complements the discussion of rising economic inequality in the US economy following the 1980s.

As stated at the introductory paragraphs, this chapter aims to present the empirical part of the thesis and intend to construct the analytical puzzles of the thesis. Having discussed the productivity increases and stagnant real wages in the US in an environment of deteriorating income distribution, two puzzling question remains: the major puzzle is to answer why even if the broader segments of the society were the losers (at least in the relative sense) of the post-1980 economic policies, did they support these governments implementing these policies? Or, in other words, how the policies in favor of small elite could be implemented in a democratic setting? The next chapter will broadly discuss this issue and aim to present a plausible answer to this question.

Figure 3.5 Average Hourly Earning For All Private Non-farm Workers



Source: The illustration is retrieved from Visualizingeconomics.com Website. The original data were obtained from Bureau of Labor Statistics. The validity of the illustration was checked from the original source by the author.

The second question is a puzzle itself. On the other hand, it helps to answer the first and major question of the thesis: How the level of consumption and standard of living increased in the American society for typical American families even though the real wages and household incomes remained stagnant? The next part sets the empirical and analytical debate on consumption patterns and increasing debt in the US economy.

3.3. Consumerism and Debt in American Society

A decade ago, Harvard professor Juliet B. Schor published her influential book, *the Overspent American*, stressing how American society had been entrapped in 'work and spend cycle'. She characterized most of the population in the US with an insatiable desire to consume in order to acquire a social status. Most often the benchmark had been the neighbors around or the characters appear frequently in the popular media. According to Schor (1998. 11), throughout the 1980s and 1990s, middle-class Americans consumed in an increasing pace: according to the modest calculations average person's spending increased 30% between 1975 and 1995. The sociological trend has also stimulated the upward shift in consumer aspirations as evidenced by the surveys measuring how much individuals need to fulfill their desires.[21] The median answer of respondents in1987 ($50.000) more than doubled by 1994 reaching $102.000 (1998:14-15). Unlike the increasing amount to realize expectations, economic conditions deteriorated for the broader segment of the

[21] Individuals were asked to respond to the question: 'how much income per year would you and your family need to fulfill all of your dreams?"

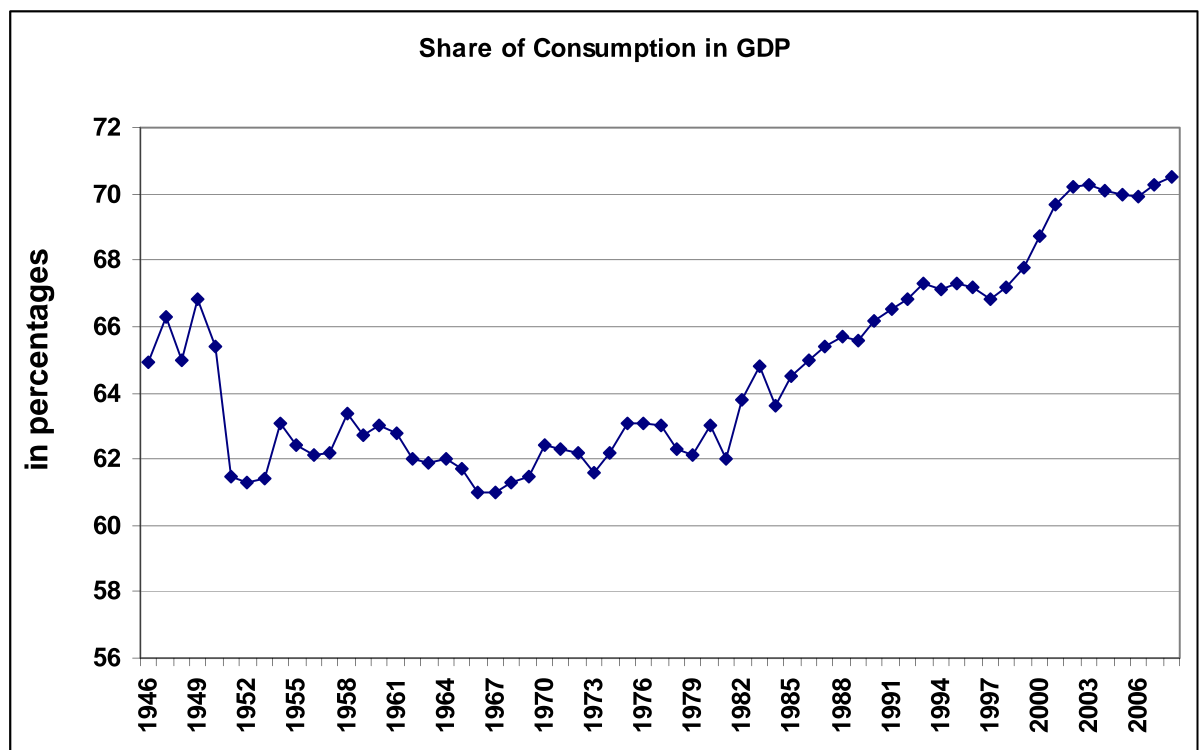
American society throughout the 1980s and 1990s. How, then, they were able to continue consuming?

Unlike the stagnant wages in the post-1973 period, the share of consumption in the GDP increased (Figure 3.6). The bulk of the population continued to consume (even in an increasing manner) and protected their standard of living in an environment of stagnant real wages. One may object to the argument supported here on the grounds that it might have been the affluent in the society who made the contribution to the high level of consumption in the post-1980 period. The previous discussion on income inequality showed that the top 1% of the American society have been doing extremely well in the age of deregulations and neo-liberal globalization. It might be the case that this smaller fragment of society who has been doing most of the consumption, and the rest remained stagnant in terms of consumption alongside with their stagnant incomes.

However, in an interesting study, *The Millionaire Next Door,* Stanley and Danko (1996) argued that the wealthy people do not consume as the popular image expects them to do so. Indeed, according to the interviews and surveys conducted by the authors, most of the millionaires pursue a modest life –even frugal- with non-luxury cars and houses in middle-class neighborhoods. Recent research on consumption patterns of middle-class in the US by Prince and Schiff (2008) confirmed that the households with an annual income of $50000 and $80000 still find themselves with mortgage payments, tuition bills, and other expenses even though their wealth had reached million-dollar marks. The research on the affluent in the American society

confirms the idea that overconsumption in the US is not confined to the affluent in the society and their luxury spending. Rather, different segments of the population have been involved in this process.

Figure 3.6 Share of Consumption in GDP



Source: Bureau of Economic Analysis

American society devotes more than 70% of their economic output to consumption. The share of consumption in the GDP has been historically high in the US. Recent years have witnessed a rise in the share of consumption. Many scholars pointed out the centrality of consumerism as a historically constructed social norm in the American society. Recently, Montgomerie (2009: 3) argues that "the political

consensus that defines the American standard of living is widely acknowledged as a pillar of the post-war expansion of the USA". The standards that were defined in the post-war years shaped the consumer patterns of most blue-collar American households in the roaring 1960s and 1970s. Montgomerie (2009) and Schor (1998) both claim that the middle-income households targeted to maintain their standard of living in the post-1980 period. The data on the share of consumption confirms their argument that consumption remained as a central driving force in the US in the post-1980 period.

However, as discussed in detail, middle-class incomes stagnated in the post-1973 period. Yet, middle-class households continued to spend beyond their limits of income to preserve their historically established standard of living (Montgomerie, 2009; Schor 1998). The result has been a rise in the ratio of overall consumer debt to disposable income (Foster, 2006, see Table 3.3). *Between the years 1975-2005, the household debt stock more than doubled as a proportion of disposable income.* In a sense, debt emerged as the major tool for the middle-class Americans to compensate the losses from stagnant wages and incomes to maintain historically constructed life standards. Schor defined how American middle-class engaged in to maintain the similar levels of prosperity of the post-war generation as 'defensive consumption'.

Table 3.3 Consumption and Debt in the US

	Consumer Debt	Consumer Disposable Income	Debt as a Percentage of Disposable Income
1975	736,3	1187,4	62
1980	1397,1	2009	69,5
1985	2272,5	3109,3	73
1990	3592,9	4285,8	83,8
1995	4858,1	5408,2	89,8
2000	6960,6	7194	96,8
2005	11496,6	9039,5	127,2

Source: The data is retrieved from Foster (2006). The original source is Board of Governors of the Federal Reserve System, historical Series and Annual Flows and Outstandings (March 2006).

Obviously, there is a class bias in the rising debt. The lower and middle class Americans with stagnating incomes have the largest debt in terms of their income and most vulnerable to financial distress. 2006 survey of Federal Reserve (see Table 3.4) shows that the top 10% of the population have considerably lower levels of debt in comparison to the rest of the population. The rest of the population has to devote almost 20% of its disposable income to debt service payments. The class bias is much more evident in terms of financial distressed experienced by the households. The percentage of families whose debt burden exceeds 40% of their annual income is 27% for the lowest income group. However, the same figure corresponds to 1,8% for the top 10% of the population. The lower income families do not have higher debt/income ratios but also experience higher financial distress. Reminding the fact that the latest available Fed data represent 2004 incomes and debt ratios, the figures

should have been worse for the lower income groups in 2008 and 2009, in the midst of the economic crisis with rising unemployment and financial turbulence

Table 3.4 Debt and Income Groups

Income Group	Family Debt (As a Percentage of Family Income)	Percentage of Families with more than 40% debt
Less than 20	18,2	27
20-39.9	16,7	18,6
40-59.9	19,4	13,7
60-79.9	18,5	7,1
80-89.9	17,3	2,4
90-100	9,3	1,8

Source: Federal Reserve (2006), Recent Evidences in the US Family Finances. Retrieved from http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf

The problem of over-indebtedness has always been one of the main features of postwar American society. Sociologists have pointed out the intimate linkage between debt and consumption in the US economy (Manning, 2000; Ritzer, 1995). As the political and economic environment deteriorated for the middle-class American families, the 'defensive spending' reflected itself in the attitude of indebtedness of typical American households (Medoff and Harless, 2000). Historically low interest rates and the expansion of the financial markets enabled household to spend beyond their means and plug the gap between their income and

expenditures (Montgomerie: 4). Hence, expanding financial markets helped households to consume beyond their limits, as well as increased household debt

3.4. Financialization of the US Economy

Alongside the debt and consumption linkage, financial markets constituted the third leg of 'unholy trinity' in the US economy. In recent years, financial markets successfully managed to integrate individuals, households and the firms to the financial system through new means of mediation and new financial tools (Montgomerie, 2009; Froud, Leaver and Williams, 2007). Similarly, the role of the finance in the economy has considerably risen. Growing importance of finance in the world economy has been noted by scholars and the concept of 'financialization' had been introduced to define financial expansion in the economy.[22] Arrighi (1994) argued that the rise of finance stemmed from intensified competition between capitalist states during hegemonic transition. According to Arrighi, declining rate of profits in the industrial sector led many capitalists either to transfer their economic activities into the realm of finance or financialize their manufacturing activities. Based on Arrighi's conceptualization of the term, Krippner (2005: 174) defined financialization as a "pattern of accumulation in which profits accrue primarily through financial channels rather than trade and commodity production". Some scholars also pointed out the central role of financial deregulation and broader economic policies in the neoliberal age to explain the rise of finance in the post-1980

[22] For a discussion of the financialization literature and its repercussions in the US economy, see Krippner (2005) and Orhangazi (2008a).

period (Dumenil and Levy, 2005). Others have identified how financialization of economies caused changes in the social structures and produced extreme wealth and income polarization in recent years. For instance, Kevin Phillips (2002) argued that the financialization of the US economic eroded the social fabric of the American democracy. Philips' argument rests on a similar analysis of rising income inequality and how middle-American families have been dealing with stagnant incomes.

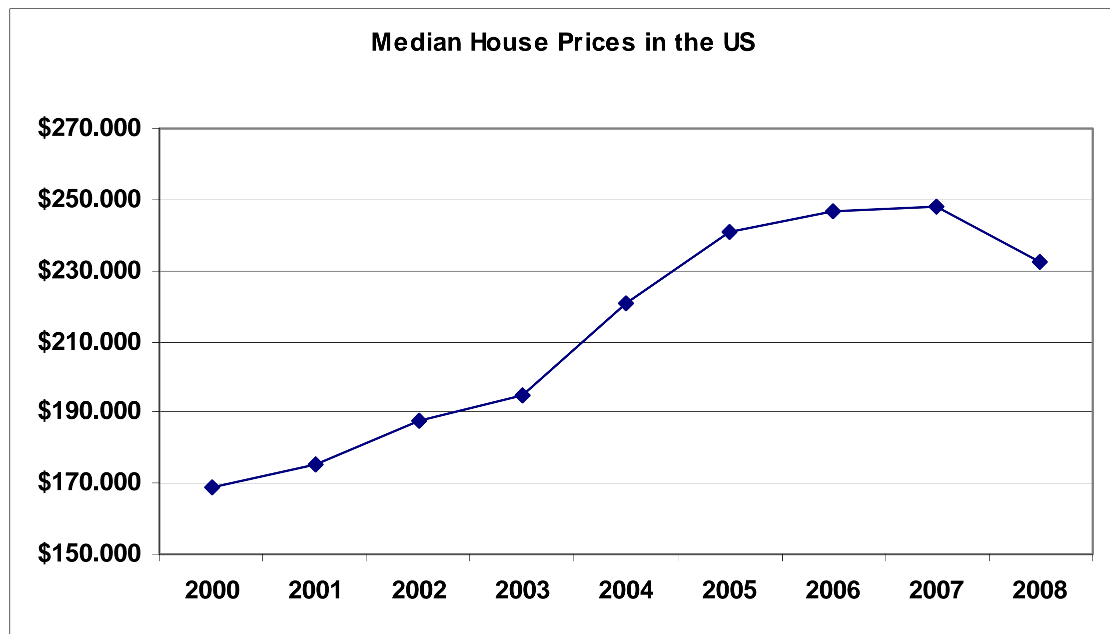
The US has been one of the countries who have experienced financialization in its extreme form. Krippner (2005) and Orhangazi (2008a) portray a careful examination of the dynamics in the US in recent years in terms of financialization. Krippner shows that the role of finance in the economy increased significantly, but manufacturing pursued a counter-trend: While the share of manufacturing in the GDP was around 30 to 35% throughout the 1950s and 1960s, this role dropped to 15% in the 21st century. In contrast, the role of finance in the GDP increased to 25% in this decade from 10% in the 1950s. Especially after 1980, share of finance have risen dramatically in the US (Krippner: 178). In this respect, Orhangazi (2008a, 2008b) argues that two different historical terms can be identified with respect to US economy. Between 1952 and 1980, the state intervened into economy much more directly and constrained and regulated financial activities. However, in the post-1980 period with deregulations and financial innovation, the role of finance in the US economy considerable rose. According to Orhangazi (2008b), similar trends of financialization are evident in the behavior of non-financial firms and their engagement with financial instruments. In the post-1980 period, non-financial corporations intended to benefit from financial operations and transformed their

manufacturing practices in line with the ascendancy of stock market practices and 'shareholder value' (Lazonick and Sullivan, 2000). As such, the volume of transaction in the New York Stock Exchange rose from 3 million $ to in 1960 to billions of dollars in the 21st century (Orhangazi, 2008b).

The expansion of financial markets in the US has been due to deregulations and financial innovations that made new credit channels and financial tools available. Also, loose monetary policy and low interest rates, low inflation and expansionary fiscal policy due to military expenditures have all contributed to the expansion of financial markets (Stiglitz, 2003; Crotty, 2008; Phillips, 2008). New innovations in the credit market and new tools to disperse the risks have also transformed conventional banking practices (Eichengreen, 2008; Montgomerie, 2009). Rather than acting as intermediaries between borrowers and lenders, banks started to directly trade on debt and equity markets. The abolishment of Glass-Steagall Act - enabling the merge of commercial and investment activities- evidently facilitated the process (see Chapter 2). Thus, the incentive for the banks were no longer to check whether the borrower is able to pay the credit back, but to structure and hedge the credits so that the risk can be distributed and resold. In such an environment, credit issuers have been only dependent on stable sources of income to create new asset streams (Montgomerie: 4; Leyshon and Thrift, 2007). To Montgomerie, hence, the new financial system had to have households and individuals to grow and make profits.

Households and individuals, therefore, have been an integral element of the new financial system. The finance-led growth of the 1990s and 2000s rested on the expansion credit markets for new investment, consumption and mortgage credits for the housing market. As household consumption augmented the credit markets and lead to financialization, financialization helped household to overcome stagnant wages and enable them to consume beyond their limits. The policies pursued by the governments and Fed in the 1990s and 2000s also supported the expansion of credit markets and consumption. It was believed that falling inflation rates in the post-1980 period helped nominal interest rates to decline, along with sophisticated financial instruments, allowed more credit available for household consumption. Individuals and households, as rational individuals, responded to this changing environment borrowing easily and cheaply (Stiglitz, 2003; Montgomerie, 2009). The mantra of the politicians, scholar and financiers in this period was that the expansion of credit markets enabled cheap credit for the greater segment of the society, as well as through new derivative instruments, risk is distributed successfully so that no one will get hurt out of it. Moreover, the increase in the asset and house prices allowed households to realize gains from the financialization process. In an economy guided by 'rational individuals', everything seemed quite happy and healthy for all.

Figure 3.7 Median house Prices in the US



Source: US Census Data

However, the critics argued that growth in such a finance-led regime would be dependent on permanent optimism of rising values in stock and housing markets (Boyer, 2000; Foster, 2000). Indeed, as Brenner (2002) stated ironically, it was the presence of credit markets why stock and asset prices were rising. As expected, such a mutual relationship between prices and credit markets created a credit and housing bubble, supported by low interest rate policies of Fed in the post-2000 recession. As Figure 3.7 clearly demonstrates, median house prices increased well beyond the inflation and growth rate. *Between, 2000 and 2005 (the year where the boom in the market were slowed down), median house prices increased 42%, whereas the inflation rate rose 13% only.* It was evident that the prices could not increase permanently. Nonetheless, engaging in leveraged credit business was so profitable that no one in the market wanted to be out of the business. As long as the prices

soared, everybody was happy: financiers was making high profits, households were enjoying cheap credit to finance their debt and over-consumption, as well as enjoying the fictitious wealth effect of their rising assets and houses.

In other words, in an economy where most of the population felt the pressure of consumption as a social norm but constrained with stagnating incomes; expansion of credit markets made cheap credit available to compensate the difference between expenditures and incomes for middle and lower class Americans. Finance industry, on the other hand, made incredible profits through innovation of new financial instruments, which are immune of regulation and differed from conventional banking practices, as well as engaged households to introduce new streams of credits. Here is the unholy trinity in making: over-consumption, rising debt (due to stagnant incomes) and financialization.

3.5. Linking the Dynamics of the US Economy

The central objective of this chapter was to provide empirical evidence for the subsequent analysis of democratic origins of the current financial crisis. This part shared a number of empirical facts regarding the US economy and pointed out how these broader trends can be evaluated within an analytical framework. The central observation of this chapter was the growing inequality in the US in the last three decades as evidenced by the Gini indicator. During the same period, the US economy was able to grow in a stable manner and most of the growth was achieved with the increases in productivity. However, the real wages were stagnant throughout these

decades. In other words, the gains of economic growth were not shared by the lower and middle class members of American society.

On the other hand, empirical evidence and previous studies clearly show that the share of consumption in the GDP increased in the same years. A number of studies also put forth that it was not only the higher classes, but almost all the segments of the American society joined the joyous process of consumption. Based on the previous data on income inequality and stagnant wages, the legitimate question emerges is that how the lower and middle Americans were able to finance their 'over-consumption'. The answer can be found on the fact that the broader segments of society were expending well beyond their means. This pattern manifested itself in the increasing share of consumer debt. In a sense, stagnant wages made households unable to consume as they were in the previous decades. However, as sociological studies pointed out, historically constructed standards of living in the New Deal years stimulated households to consume beyond their incomes in the post-1973 period. Another interesting development contributed to this process. As I examined in chapter two and with regard to the concept of financialization in this chapter, the financial deregulations led to a new financial architecture that is able to create cheap credit for everyone. In other words, financialization of the US economy facilitated credit options on the side of the lower and middle income Americans to compensate their losses through deteriorating income equality and stagnating real wages.

CHAPTER 4

SOLVING THE PUZZLE: DEMOCRATIC ORIGINS OF CRISIS-MAKING

> "You can fool all the people some of the time and some of the people all the time, but you cannot fool all the people all the time"
>
> (Attributed to Abraham Lincoln, 1809-1865)

Previous chapters have shown that most of the changes in the realm of finance took place in the last three decades as a part of broader neo-liberal turn in economic governance of the US. Alongside with major tax-cuts, reduction of social spending and emphasis over monetarist policies to reduce inflation; major sectors (energy, transportation etc.) were deregulated and privatized with an unprecedented reliance on markets. The lack of regulation and perverse incentives of top managers in these corporations culminated with the scandals in California energy market and high-tech bubble. For example, the Enron scandal was a major warning to the US economy indicating how lack of regulation and supervision make markets less efficient and crisis-prone. Similarly, as I discussed widely, the deregulation of finance enabled financiers to innovate new derivative instruments and expand the scope of financial markets, as well as incorporated broader segments of the society into the process of

financialization. Much more importantly, all of these changes occurred through legal and institutional changes. The relaxation of supervision and regulation were further complemented with the repeal of Glass-Steagall Act in 1999, removing the barriers between commercial and investment banking and enabling these institutions to merge with each other. In short, liberalized and deregulated markets occurred as a result of choices by Republican and partly Democratic governments and were institutionalized through a legal process.

Previous chapters also discussed how inequality has risen in the American society in the last three decades even though the productivity increased and economy grew. The previous analysis on the history of economic inequality in the US revealed that the gains from the growth of economy were not distributed evenly in the last three decades and the gap between the rich and poor has widened in the same period. In contrast, in the post-war boom of 1950s and 1960s, where middle-class blue collar families emerged within an expanding industrial economy, economic equality improved and middle-classes constituted the backbone of American society. However, the post-1973 period not only witnessed major economic shocks, regression, rising inflation and unemployment but also rising economic inequality. While the upper segments of the society have grown extremely richer, the middle and lower classes in the US remained stagnant in terms of their household income.

Combining these two broader patterns in American economy, I argue that the last thirty years of American political history constitutes a puzzle: How could it be politically feasible that the deregulation of finance (and broadly neo-liberal policies)

be legalized and institutionalized in a democratic system, where most of the population seems to be the losers of this process in the long-run? Setting the puzzle, first of all, I assume simply that democracy is the rule by the 'people'. I will elaborate on this point but for simplicity democracy can be accepted as a type of regime where citizens have an influence over the government and on the political system through elections (voting) and other control mechanisms. Pressure over politicians to be re-elected is the major source of responsiveness for the electorate in times other than elections. Secondly, I assume that individuals are rational actors and are informed about their interests, policy options, and which policies would serve to their interests. Thus, ordinary citizens would be expected to vote and influence the government (members of parliament) in line with their revealed preferences (interests). As a corollary to this second hypothesis, one might expect an ordinary American citizen to resist stagnant real wages and rising inequality in American society through democratic means, i.e. voting to candidates and/or parties who offer more equal economic policies, better welfare arrangements, as well as through pressure groups to lobby for better conditions. In other words, individuals are expected to pursue their material and economic self-interest. Henceforth, it is also highly likely that different income groups in the American society would have diverse interests and there might have been a relationship between economic class of individuals and their political behavior.

It is evident that the majority of the population was the relative losers of the economic policies that were followed in the last thirty years. On this preliminary basis, I will present four separate and complementary alternatives to offer

alternatives to solve the puzzle. The first three alternative scenarios have been based on the critical evaluation of the aforementioned three assumptions on the nature of democracy, individual rationality, political behavior and class voting: First of all, democratic regimes might not be as responsiveness as I simply assumed and power and/or economic elites might be more influential than ordinary citizens in shaping policies. Hence, even though it was to the contrary of the larger segments of the society, economic elites might have been able to mobilize their resources for further deregulation and to lay down the rules that serve to their interest and make them much richer and powerful. Secondly, ordinary citizens might pay little attention to politics, might not have detailed information about the complex structure of political processes, about the details of acts and legal procedures, and much more importantly his/her opinion might be shaped through hegemonic ideology and its institutions (educational institutions, media, expert publications etc.). Thirdly, it might be the case that other moral, political and cultural factors prevail over economic interests and ordinary citizens might have voted in favor of these preferences rather than his/her economic interests. Last but not least, it might be the case that rational citizens who are aware of the fact that their ability to influence politics is limited due to economic elites and/or the institutional structure of American politics might have chosen to accept economic inequality (which means loss in the long-run) in favor of short-term contribution of finance boom to compensate their losses and to sustain their living standards. Also, concerns for moral, racial and security issues might have contributed to their tacit concern for legalization and institutionalization of deregulated finance.

4.1. Who Governs? Economic Elites and Ordinary Masses in American Democracy

Representative democracies have been thought as the most responsive political regimes due to the fact that elections provide ordinary citizens to delegate their power to their representatives. Hence, from the perspective of the electorate, choosing between candidates (parties and/or members of parliament) also mean choosing between policy options and diverse interests. As such, it can basically be assumed that elected officials or members of parliament should be responsive to the demands of their electorate. It is not necessarily because they are honest or loyal but they have an incentive to be re-elected. Therefore, they should follow the policies that appeals to his/her electorate.

On the other hand, such a depiction of democracy with respect to the relationship between electorate and the representatives is based on simple assumptions and inadequate to identify the dynamics in state, market and societal relations. Even though in consolidated democracies every citizen has right to vote, freedom to organize a pressure group and become a candidate to public offices, it is very doubtful that all interests in the society are evenly represented. It is evident that upper classes in the society have necessary resources to be mobilized for political action to influence politicians and public officials in line with their interests. In this regard, the ability of ordinary citizens to shape policies in democratic systems might be much more limited than the simple models of democracy predict.

The task of this part, therefore, will be to discuss the responsiveness of American democracy with respect to preferences of lower and middle class Americans and the extent to which economic elites have ability to influence the political outcomes. Such an analysis might yield positive contributions to solve our puzzle with respect to rising inequality and increasing financial openness in the US economy in the last three decades. If American democracy is characterized with high level of elite influence and lack of responsiveness, I can argue that the puzzle indeed is not a puzzle in the sense that elites were able to implement neo-liberal policies without the support of large masses. However, such an argument should explain why post-war period were characterized with rising equality and better conditions for the middle-classes of American society. If American democracy has high level of responsiveness, then we should think of alternative explanations for the puzzle. The level of democratic responsiveness, thus, will have a major role in my argumentation.

The analysis of democratic responsiveness is also crucial for theoretical reasons. I have examined the institutionalist perspective in the first chapter and provided the reasons why I have based the structure of the thesis on this framework. As North (1990) and Hall (1986) argue, institutions are the broader patterns shaping the rules of the game in human interaction. Following this definition, one can easily identify democracy as a broader institution structuring the relations between actors and determining the rules of the interaction. On this basis, I argue that even though economic elites are influential and able to shape the political decisions, they have to respect to the general will and use much more subtle ways to influence politicians and public opinion. Moreover, institutionalist framework also reminds us that there is

a dynamic relationship between institutions and interests, which evidently shows itself through the distribution of power. Thus, examining the role of economic elites and how they shape political institutions might serve potential contributions to the theory-building process as well.

4.1.1. What Democracy is and is not?[23]

Before elaborating on the responsiveness of American democracy, looking at the origin and definition of this political regime might be useful. Democracy has been a catchword if not self-fulfilling prophecy in political science referring to a particular mode of regime. The term gained particular importance and wider circulation with the third wave of democratization after the fall of Soviet bloc.[24] In contrast to broad circulation of the term, democracy as a term was stretched conceptually so far that it is hard to put a certain definition of it. In fact, more than 500 sub-types of democracy were detected with a careful examination of the literature (Collier and Levitsky, 1997). Nevertheless, it is fair to say that the word 'democracy' comes from the Ancient Greece and literally means the 'rule by the people'. However, As Anthony Birch (2001) argues, the concept itself does not provide a particular model for governance. Indeed, the assumptions and practices of democracy in Ancient Greece were very different from what is understood today. For example, only small minority of citizens were entitled to participate in the governance of city states in Ancient Greece, which only included adult male citizens. Furthermore, the governance was

[23] I borrow the title from Schmitter and Karl (1993)

[24] For a collection of essays please see Diamond and Plattner (1993). Hungtinton's (1993) piece may be particularly helpful in terms of identifying different waves of democratization.

based on direct participation. It is obvious that contemporary democracies target all adult citizens to participate into political process but due to practical reasons participation should be representative. In fact, the heritage of contemporary democracy does not go back to Ancient Greece but the history of Western Europe and the United States in the 18th and 19th century. According to Birch, the democracy in the modern sense has been borne out in the course of 19th century as representative government (Birch, 2001; Held, 1996).

The US was one of the first political democracies that entitled certain rights and extended suffrage to its citizens. The constitution of the US targeted to design a de-centralized state and a pluralist society. The biggest concern for the founding fathers was to prevent the domination of a certain majority over others. One of the factions in the society might have easily prevailed over others and such a situation might have led to the 'tyranny of majority'. Hence, James Madison supported the idea that factions in the society should be so small and diverse to reduce the effect of each other and not be able to dominate the political system (see Federalist Papers no.10). With all these characteristics, democracy in the US emerged with certain emphasis over minorities and pluralist interest intermediation.

The defenders of pluralist interest intermediation in the US argue that there are so many diverse interests and intersecting cleavages in the US society that makes the American democracy work (Dahl, 1956; 1978). Robert Dahl indeed uses the term *polyarchy* to depict that US democratic system is composed of many diverse sources of power and interest groups. Similar to Schumpeter's (1950) procedural definition

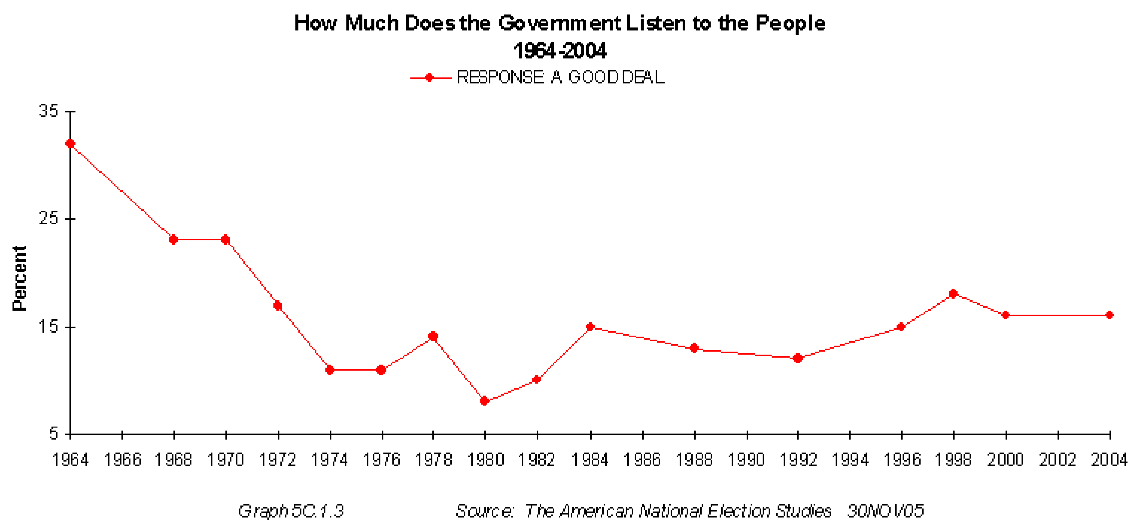
of democracy, Dahl's conceptualization also refers to the minimum characteristics of a working democracy with reference to right to vote, freedom of expression, joining political organization and candidacy to public offices. Whatever the formal requirements, both of the scholars appreciate the centrality of public opinion responsiveness as a central tenet of democracy. Similarly, focusing on the responsiveness and accountability to citizens, Schmitter and Karl (1993: 50) argued that the "modern political democracy is a system of governance in which rulers are held accountable for their actions in the public realm by citizens, acting indirectly through the competition and cooperation of their elected representatives". According to these scholars, democracies do not necessarily yield more efficient political and economic regimes, nor they necessarily produce stable regimes. However, democracies should guarantee basic freedoms and rights of citizens to carry their interests and choices to political process.

4.1.2. Responsiveness in the American Democracy

In the second half of the 1990s, Nye and his colleagues (1997) observed that there has been a secular decline in the public trust in government. They asserted that quite a bit of people do not trust government and the figures are incomparable to 1960s in terms of public confidence. The survey data on electorate perception also confirms the decline in public trust. According to American National Election Survey (ANES) data most of the people think that government do not listen to the people, do not run for benefit of all but only a few big interest, and great deal of officials are corrupt. Figure 4.1 shows that while almost 30 % of all of the respondents answered in a

positive way to the question “how much government listen to the people”, with the 1970s there is a visible decline in the percentage of positive answers. The figures enhanced slightly after the 1984 election and almost stayed at 15 % level for the last three decades.

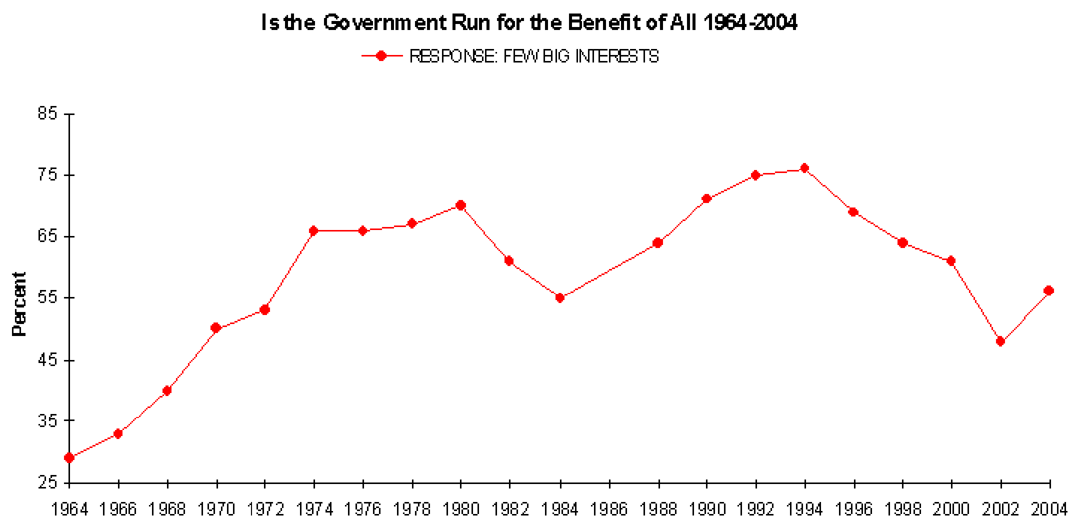
Figure 4.1. How Much Government Listen to the People



Similarly, Figure 4.2 indicates that great majority of respondents think that governments do not serve to the interests of public but only a small minority of ‘big interest’. A number of trends can be identified from the data. First of all, confidence in government in the 1960s in terms of considering the interest of public was obviously larger. However, the perception deteriorated throughout the 1970s and 1980s. Secondly, the trend has changed in the mid-1990s with the second of term of Clinton administration signaling a policy shift. As I discussed in the previous chapter, Clinton administration had to solve huge government deficits and had to curb their enthusiasm for social spending in their first term. However, in Clinton’s

second term with the help of roaring economy, Clinton administration was able to improve social security system and partly stopped the trend towards economic inequality.

Figure 4.2 Is the Government Run for the Benefit of All?



Apart from observing the broader trends of responsiveness of the American democracy, two conclusions can be drawn from the data regarding our purposes: One is that there is a congruence between economic equality and public confidence in governments with reference to responsiveness and the perception that public's interest is represented by the governments. The other conclusion is that even though public might not be able to follow day-by-day politics and uninformed about the details of the political processes, it is capable of capturing the broader patterns and evaluate the governments' performance on the basis of responsiveness.

There are several reasons to the decline of public trust in government. From an economic perspective, Robert Lawrence (1997) argued that economic slowdowns and global competition can partly explain the decline of confidence. Rather, changes in the industrial production and rise of service economy led to a decline in the economic role of middle-class blue-collar workers, which at the end created unemployment and dissatisfaction. On the other hand, James Mansbridge (1997) proposed that the decline of social capital were the main reason behind such a decline in confidence to governments. According to Mansbridge, the broader social changes lead a decline in the ability of people to work together with the help of trust, norms and networks that facilitate coordinated action. Similarly, Inglehart (1997) discussed how post-materialist values lead a decline in the respect for authority in the context of American public distrust. Others (King and Neustadt, 1997) focused on the political factors as the realignment of political parties and the end of Cold War as the major explanatory reasons for the decline of confidence. Whatever the reasons are, there is a general consensus on the idea that American people trust their governments less than they did in the pre-1973 period.

4.1.3. Two Perspectives on Democratic Responsiveness

There are two alternative perspectives on the extent of responsiveness of public officials in democracies. Scholars who stress the role of elites argue that economic and political elites have enormous power to shape policy outcomes and public opinion. According to this perspective, political competition is not a neutral process but based on class struggle. Especially dominant classes in the society influence the

political processes to secure and enhance their role in the society. On the other hand, pluralists and other schools (state-centered theorists and neo-Marxist who stress the relative autonomy of state) indicate that society is composed of many diverse interests and it is almost impossible to think of a unified elite class that shapes policies. Furthermore, state-centered and neo-Marxist perspectives stress the autonomy of state institutions vis-à-vis capitalist classes. In this part, I will review the arguments of two perspectives and also discuss empirical studies reminding that the problem is an empirical puzzle as it is a theoretical one.

The proponents of the idea that certain groups of individuals (whether they are called power elites, upper classes or economic elites) emphasizes the role of particular group that is able to govern and control political systems of nations. One strand of elite theory has found its origins in the works of Pareto, Mosca, Michels and Mills. These scholars emphasized the central role of power elite in the governance of nations and inevitability of oligarchic structures even in modern political systems. For example, Robert Michels' concept of 'iron law of oligarchy' was a critical remark for any type of political organization. Michels' analysis indicated that even socialist and social democratic parties of Europe have tendency to turn into oligarchic structures due to leadership and immobility of the masses (Michel, 1915). Another strand of the perspective comes from the Marxist idea that capitalist bourgeoisie as the dominant class mobilizes its resources to control state apparatus. Miliband (1969) and Domhoff (1990, 2006) emphasized the class origins of power and empirically supported the idea that there is a greater interaction between power elites and capitalist class (Akard, 1992: 599). In both strands, the common point is

that upper classes have been depicted as the architects of major policy outcomes and changes.

These theorists suggested that the general will of public in the US may be restricted due to the pressure of well-organized business groups and members of upper class in the society. Schattchneider (1960), for example, argued that democratic structures are only 'semi-sovereign' due to the structural power of upper classes. In this respect, Domhoff (1990, 2006) questioned how can extreme corporate domination be possible in a democratic country such as US. To Domhoff, what makes elites tied to each other is the existence of a set of social upper class institutions such as gated neighborhoods, private schools and exclusive social clubs. He also examined the ways how these upper class members shape the policy outcomes and particularly emphasized the role of campaign contributions in shaping the preferences of politicians. Thomas Ferguson and Joel Roger (1986) further contributed to this argument claiming that these upper class members "invest in politicians in the same way that they invest in stocks, always seeking specific payoffs in terms of policy changes" (Domhoff, 1990: 225). Mitchell (1997), on the other hand, stressed the idea that incumbent politicians need strong economy to be reelected, that is why, they need the power of capital to increase its chance to win the elections. Hence, "the necessity for politicians to sustain the economy supposedly restricts policy choices and hinders responsiveness by officeholders to constituent preferences" (Smith, 1999: 843; Elkin, 1985).

The resources and organizational ability of these elites enable them to interfere into political decision-making and policy implementation process at various levels in the US. Akard (1992: 559) states that elites can intervene into political system during the candidate selection and electoral influence, policy formation, by influencing the state officials, at the stage of policy implementation through lobbying and via establishing ideological hegemony through the influence of public opinion.[25]

The institutional structure of American politics and the dynamics of elections (costly political campaigns) enable business community and the other pressure groups that can mobilize their resources to affect political outcomes. One of the strong features of the American politics is the single-member plurality system that requires plurality –not majority- in the selection of Senators and representatives. Such an electoral system necessarily leads two a two-party structure helps the political system concentrate around centric forces and mainstream parties.[26] Radical political stances and heterodox views can hardly be represented in pluralist systems and political parties tend to be centric.[27] Similarly, the President is endowed with greater role and rights to shape policies. Such a political system enable wealthy donors to influence political outcomes more in comparison to political systems with multiple parties, coalition governments and proportional representation electoral systems. In parallel to this, Domhoff also (2006: 147-8) argues that "in an electoral system where party

[25] Also see Domhoff (1990) and Miliband (1969) on this point.

[26] The statement that 'single member district system (plurality) necessarily leads to a two-party system' had been put forth by French sociologist Maurice Duverget (1972) and the concept is famous with so-called 'Duverget's law'. Sartori (1990) examines the nature and limits of the relationship between electoral and party systems. For different types of electoral systems, please also see Andre and Louis (2002).

[27] For the theoretical underpinnings and a comparative analysis of party systems in major industrialized democracies see Gallagher et. al. (1992).

differences become blurred for structural and historical reasons, the emphasis on the character and image of the candidate becomes very great along with a concern about her or his stance on social issues… because the candidate selection process is relatively individualistic, and therefore dependent upon name recognition and personal image, it has been in good part controlled by members of the power elite through large campaign contributions". Therefore, to secure the support of wealthy donors is one the most rational strategies for the Senators and representatives.

Following the mid-1970s, the nature of financial contributions to the political campaigns changed. Campaign contributions have always been a central element of American politics. However, prior to 1974, campaign contributions were mostly informal and not regulated by the laws. After 1974, special interests have been required to report publicly the amounts of money they contribute to congressional candidates. Furthermore, organizations such as corporations, unions, or professional associations are not allowed under federal law to make campaign contributions directly out of their general treasuries. All campaign contributions must be made from a separate organizational entity (Wright, 1996). In order to follow the legal procedures, corporate business established Political Action Committees (PACs) as an institutional body to control and transmit direct contributions to the members of Congress and to political campaigns. [28] PACs, thereby, have been the central institutional structure in American politics channeling financial contribution to political campaigns and affecting political outcomes in favor of the donors.

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[28] For more information on PACs and how big interest influence political outcomes, see Clawson, D., Aland Neustadtl, and Denise Scott (1992) and Clawson, D., Alan Neustadtl, and Mark Weller (1998).

Elite theorists contributed to the study of democratic responsiveness emphasizing that the influence of organized elites can hamper the general will of the public. On the other hand, these theorists have been criticized on the grounds that the interests and objectives of these elites are not unified and they do not constitute a coherent group. Indeed, these theorists –at least most of them- do not state that there is a coherent group of individuals who follow similar objectives. Instead, what they argue and empirically support is the conditions that make intra-elite cohesion and unity feasible. For instance, Domhoff (2006) examines the 'corporate-conservative' coalition in the US joined by Christian Right that shaped American politics in the last decades. Domhoff argues that Christian Right brought conservative middle-class religious groups and their interests in a variety of social issues including abortion, prayer in schools, homosexuality. Domhoff recognizes that the coalition is sometimes an uneasy one since the priorities of Christian Right and corporate community does not always match. Nonetheless, these groups consent and work on their common mistrust of government power. Similarly, Akard (1992) accepts that conflicting interests within business and corporate community exist in terms of certain cleavages: financial vs. non-financial, manufacturers vs. retailers, defense vs. non-defense and MNCs vs. regional firms. Nonetheless, Akard (1992) acknowledges that certain conditions make business unity possible. He asserts that "social, political, or economic conditions that threaten the perceived interests of capital are likely to call forth a political response" by these groups. In such cases, a common set of interests foster class-wide political response. For instance, economic stagnation and the rising global competition undermined the post-war liberal arrangements and enabled business community to cooperate and unify. The business community

mobilized its resources and enhanced its organizational capacity through PACs. These committees channeled funds to sympathetic public officials and candidates for office (Akard: 602). Unified support of business community towards Ronald Reagan yielded positive results with the Economic Recovery Tax Act of 1981 that reduced taxes in favor of business community. These scholars, in other words, do not argue that elites or the upper class is a unified community but they examine the conditions which makes their cooperation less likely and its effects on policy outcomes.

In contrast, pluralist and other state-centered theories reject the notion that business community and upper classes dominate state institutions and prevent policy responsiveness. Pluralists (Dahl, 1956, 1978; Lindblom, 1977) contend that business interest is only one of the diverse interest and pressure groups in the American society, and it is indeed diversified within itself. Hence, pluralists disagree with the dominance of business community and its ability to shape political outcomes. On the other hand, state-centered theories (Evans et. al, 1985) and neo-Marxist who emphasizes the relative autonomy of state (Poulantzas, 1974, 1980; Offe, 1984) associated certain level of autonomy to state managers and institutions. Therefore, these schools, as well, do not regard capitalist or upper classes as capable of dominating the state and other institutions of democracy.

The supporters of the democratic responsiveness thesis predict high level of congruence between public opinion and policy outcomes.[29] The theory assumes that politicians should be responsive to the demands of the electorate since the main

[29] For economistic theories under the assumption of perfect information, see Downs (1957)

incentive of the politician is to remain in the office and to be re-elected. Hence, politicians should response to popular demands and serve to the public interests. On this basis, Page and Shapiro (1983, 1992) tests the responsiveness of American democracy examining the congruence between public opinion change and policy change on salient issues. They find substantial congruence between public opinion change and public policy change and confirm that American democracy is mostly responsive to public demands. They also offer evidence for the statement that public opinion is a proximate cause of policy, more often than the reverse. Yet, Page and Shapiro (1983: 175) warns the students of American politics that "one should be cautious about concluding that democratic responsiveness pervades American politics". There are a few points that should be taken account seriously: less salient issues might be overlooked, there are cases with no policy change after opinion changes, and there are still non-congruent cases and many example of reverse causality (policy affecting opinion). All of these points indicate the necessity of a cautious attitude before claiming absolute responsiveness in American democracy.

Testing the same empirical question, many scholars studied the effects of organizations or class mobilization with respect to their effects on public policy outcomes. For example, testing the effects of labor organization in shaping public policy in the American states, Radcliff and Saiz (1998) found that "labor organization profoundly affects public policy. The greater the organizational strength of labor, the more states spend on welfare, education, and other activities… [Also], the larger the share of workforce represented by unions, the more progressive the tax code and the more liberal policy in general (1998: 121). Appreciating the

responsiveness of public policy towards labor union strength, Radcliff and Saiz, on the other hand put forth that unionization in the US dramatically declined in the last decades[30], which has serious impacts for democratic politics. Radcliff and Saiz (1998: 122) argue that "without unions to speak for them, the working class has moved to toward political 'invisibility'.[31] In other words, though labor organizations are effective means for the working class to intermediate their interests to the political systems, the organizational capacity and political influence of these trade unions had been diminished in the last decades.

The decline in unionization and the loss of organizational capacity in labor unions was not a neutral process. Krugman (2007) and Domhoff (2006) iterated the centrality of labor union decline with respect to democratic deficit in the US and showed how business community through PACs not only promoted tax-cuts and other supply-side policies but targeted to reduce the capacity of labor unions to affect political outcomes. A number of changes in the Labor Act by the Republican governments with the financial and ideological intended to reduce the role of labor unions and create disincentives for labor union membership. Michael Goldfield (1987) also agrees with these accounts on the point that the decline of labor organization in the US was not an outcome of structural, economic, geographical or demographic changes. Instead, changes in the political opposition of employers and the public policies favoring employers diminished the strength of trade unions. In this respect, Reagan administration had been characterized with record-low wages

[30] On the decline of unionization and the loss of organizational capacity in labor unions please see Goldfield (1987).
[31] For the original argument see William (1992).

and dramatic decline in union membership. Others stressed the post-war dynamics and Cold War rhetoric as the major cause of trade unions in the US (Dubofsky, 1994). The oppressive political environment of post-war era characterized with Senator McCarthy's efforts, reduced the organizational capacity of trade unions. Popular support for McCarthy investigations stemmed from the irrational exaggeration of communist threat and targeted not only left-wing and liberal intellectual but every sort of labor organization. These policies also appealed to business community with the introduction of anti-labor Taft-Hartley Act in 1947. Even though, trade unions continued to have an impact in political outcomes, their organization capacity declined continuously in the post-war era.

The decline of labor organization in the US provides a compelling case for the institutionalist theory on the legalization of power and convincing masses. For instance, the framework put forth by Acemoglu et. al (2006) explains the role and interests of business community on the basis that powerful actors intend to consolidate their *de facto* power through legal and institutional changes and turn it into *de jure* power. In this case, Republican president and majority in the Congress, financial resources to be mobilized by the business community, and ideological support of monetarist experts in an environment of economic crisis and decline of Keynesianism constituted the de facto power of business community. However, legal and institutional changes made them persistent and lead de facto power to turn into de jure one. Similarly, the case of Cold War context and the rising (though partly artificial) threat of communism in the US shows how broader segments of society

can be convinced on policies that reduces the organizational capacity of trade unions and their political influence.

Similar to the previous study, Hill et. al (1995) test whether lower class mobilization affects welfare benefits and they provide evidence for a positive relationship between the two. Designing the model, they theoretically argue that lower class political participation should create pressure for governments in parallel what is argued above. They, then, expect association between the degree of lower class mobilization and the generosity of welfare benefits provided by state governments. Thus, Hill et. al. also confirms the responsiveness argument. However, they also point that effects of lower-class turnout can be weakened in periods of unusual political and economic change like the 1980s. They indicate that 1980s have been much less responsive in terms of welfare policy responsiveness to lower class mobilization. As such, it overlaps with the idea supported throughout the thesis that post-1973 neo-liberal transformation had certain undemocratic features and influenced by the interests of business community rather than the lower and middle classes.

The debate on responsiveness of American democracy helps us to yield three fruitful results for further discussion. First of all, it is evident that elites have certain power to influence the political system though diverse means. Nevertheless, the ability of upper class is limited and far less than the elite theorists put forth, due to internal divisions within the upper class as well as the power of public as the arbiter of electoral competitions. Secondly, even the studies that support responsiveness thesis indicated that post-1973 political environment have been characterized with less

responsiveness due to unusual economic shocks and major policy changes in the 1980s. This point further evidenced by the ANES data that the public perception of responsiveness and confidence towards governments declined in the last three decades. Last but not least, the declining organizational capacity of labor unions and other lower and middle class pressure groups are likely to create democratic deficit and lead large masses more invisible in the political system. In other words, even if the responsiveness of the political system have had not changed, the declining organizational capacity of lower and middle classes led other interests (business and upper class interest) to be heard much more than it used to be in the 1950s and 1960s.

4.2. On the Nature of Public Opinion

Individuals and their opinion on political issues are the central elements of a democratic system. I have discussed to what extent these opinions can be transmitted into policy outcomes in democratic systems especially in the context of the US. However, another central concern of this part is to evaluate the public opinion itself. I simply assumed that individuals are rational and they do have knowledge about their preferences, policy options and the potential benefits of policies to themselves. However, many analysts argued that individual rationally is constrained/limited/bounded with the availability of information, cognitive abilities and time. On the other hand, others stressed how elites can shape public opinion. In the following, I will review the debate on rationality and the nature of public opinion.

Rationality simply refers to the ability of individuals having a certain set of preferences and to be able to set these preferences in order in a consistent manner. A rational individual is expected to rank their preferences in order. For example, individual X might have preferences A, B and C. Also, this individual X knows which of these preferences serve better to their interests. Let us assume individual X orders these option as respectively (as A, B and C). Such an order means that A yield more than B, and B yields more than C, it necessarily be the case that A yields more than C. Individual X, therefore, do not assign greater value to C than A. This perspective on rationality assumes that people have perfect information about their options and preferences, as well as knows the utility function (expected outcomes) of these options. However, such a simplistic and logical argumentation for rationality have been criticized on the grounds that individuals have certain limitations in reaching to the information for constituting their preferences, their cognitive ability may be limited to assess the differences between option, and time limitations may lead them to stick stylized behaviors (refers to culture) rather than critical evaluation of the options (Simon, 1955, 1990). In this view, individuals are rational but their rationality is 'bounded' with all of these constraints. If people do have perfect information about their options, preferences and expected outcomes, then, rationality assumption would have perfectly worked for almost all of the individuals who have necessary mental abilities. Unfortunately, this is not the case for most the phenomena in social and political life. Therefore, 'bounded rationality' assumption better explain the political attitudes of Americans and public opinion in general.

Students of American politics admitted that most people pay little attention to politics, have a limited understanding of their political options and do not usually develop opinion on impending legislation (Domhoff, 2006: 110; Zaller, 1992). Most of the legislation includes technical dimension that requires information, attention and time well beyond an ordinary citizen usually have and devote. Only non-technical and salient issues appeal to broader public and involve greater majority of the population. *Issue saliency,* therefore, is a crucial explanatory factor in determining to what extent public is informed about policies and their preferences. However, salient issues are generally rare and these are either moral and racial issues that people have prior preferences and prejudices or really have a direct effect on people's life such as 'bread and butter' issues -taxes, welfare, etc. On other issues, most of the people either do not have certain information, attention and preference. Indeed, non-salient and technical issues are the ones where elites have greater impact in shaping public opinion. For this reason, Jacoby (2000: 763) reminds that public opinion is not solely an aggregate characteristic of public. Rather, public opinion stems from the interaction of public and elites. In this manner, recalling the warnings of scholars studying public opinion and democratic responsiveness in the US, one should keep in mind that the causality from public opinion to policy may have reverse direction. In other words, it would be flawed to take public opinion as granted. Instead, the possibility that elites and policy outcomes affect public opinion should be taken into account seriously.

Elite influence on public opinion has been analyzed in American politics with respect to institutions and specific role of media values. Institutions have a central role in

opinion-shaping process. Public schools, churches and voluntary associations spread values and shape public opinion in the broader sense (Domhoff, 2006). Experts and academia also exerts its institutional influence on certain issues providing technical information and expertise. However, in most cases, the assumed technical information transmits the underlying ideological and value-loaded opinions. In this manner, Jenkins and Eckert (2000) discussed how Milton Friedman, Chicago School and the connected think-tanks as American Enterprise Institute were effective in the development of the new conservative policy paradigm with their emphasis and technical support for monetarist and supply-side economic arguments. Others stressed the role of media (Iyengar and Kinder, 1987; Zaller, 1992) in shaping public opinion. Domhoff (2006: 115 and 124) notes that almost one third of public relations practitioners are former journalists and media corporations have been owned by upper class members who have extensive interlocks with other corporations. A number of studies showed that how media can be effective in shaping opinion in racial issues and welfare preferences. Examining the representation of the racial issues in the mass media, Dixon and Linz (2000) provided evidence that blacks are over-represented substantially as perpetrators of crimes compared to real crime statistics. Similarly, Gilens (1999) showed that poverty news in the US has increasingly racialized and there is a tendency to associate blacks with poverty. He argues that such an association shape attitudes of white Americans to welfare policies in a negative way (I will discuss this issue in part 4.3 and 4.4). These studies indicate how media can shape public opinion and have an impact on political preferences, as well as outcomes.

Issue framing and broader clause of American society are two other dimensions of public opinion shaping in the US. Wliiam Jacoby's (2000:751) examined how elites manipulate and utilize issue framing as a political tool. To Jacoby, most political issues arise from complex problems that are remote from the direct experiences of most citizens. Therefore, information about these issues must be transmitted to the public. Elites, as the earlier analysis confirms, serve the ways "that shine the best possible light on their own preferred course of action". He also notes that there are clear differences in the issue framing of Republicans and Democrats. While Republicans focus on broad statements about policy objectives, Democrats provide more specific forms of government programs to justify their political stances on legislations and for political competitions. Others (Lipset, 1963 and 1979; McClosky and Zaller, 1984; Feldman and Zaller, 1992) discussed and provided evidence in favor of the idea that political culture in the US has been shaped around certain core values such as individualism, freedom, democracy, capitalism and competition. On this theoretical and empirical basis, Feldman and Zaller (1992) discuss the ambivalence between enthusiastic support to the welfare programs and the attitudes that condemn big government and praise economic individualism. According to Feldman and Zaller, "popular support for the welfare state in the US must continually struggle with the values of the 19th century liberalism" (1992:269). It can be argued that these American values are historical construct that have been largely shaped and constituted by the political and economic elites and today mostly shape the underlying dynamics of public opinion formation.

This part indicated that rationality argument should be refined on the basis that imperfect information is a serious obstacle for preference formation and ordering. Most of the people in the US are either uninterested, uninformed or not capable to comprehend the complex nature of policy proposals and legislations. Elites, therefore, have technical expertise, institutions, media power and issue framing opportunity to shape the public opinion. However, the saliency of the issue has a critical importance in elites' ability to shape preferences of the public. Moral, racial, and bread and butter issues generally have wider saliency since it involves broader masses, requires little technical knowledge, and almost everyone in the society has a prior knowledge on these issues.

4.3. Cultural and Non-Material Basis of Politics in the US: New Cleavages in the American Society

The third assumption in my analysis was the idea that if individuals are rational, then it is strongly expected that individuals would pursue their economic self-interests. Accordingly, one would expect that there should be differences in the political behavior of different economic classes in American society. As such, individuals with different income levels should have diverse political preferences in terms of economic self-interests (Evans, 1993). This argument is also consistent with the class-based analysis and the formation of socialist and social democratic parties in industrialized democracies. In this manner, examining the historical formation and evolution of these parties, Przeworski and Sprague (1986) argue that movements and parties in the 19th and 20th century targeted to create an association between class and

voting. They also note that late Engels thought that socialist revolution come through ballot box and the role of workers in democracies. In a sense, a strand of social analysis define the classes as one of the major –if not the most- cleavage in modern democratic societies and they define class as the major factor in explaining the variance in the political behavior of individuals.[32]

Analysis of class and political behavior in American politics have focused on the careful examination of public opinion data to inquire partisanship, party identification and policy preferences towards a number of issues as welfare spending, taxation and globalization. In this framework, it is assumed that there should be congruence between the class positions of individuals and their policy preferences. For example, an individual from a lower class background is likely to support large welfare spending and progressive taxation. The idea rests on the fact that lower income groups would benefit more with larger welfare spending and progressive taxation. Alongside, the same individuals are expected to support Democrats due to the fact that party image of Democratic Party and the programs pursued appeal to lower and middle class Americans with their emphasis on larger welfare spending, progressive taxation and concerns for poverty and inequality. A number of analysts have identified the differences between Republicans and Democrats in terms of these policy measures, and put forth that Democratic officeholders are generally more liberal than Republicans in welfare spending and progressive taxation (Stonecash et.al., 2000: 736; Aldrich, 1995). Democrats are also more likely to spend on education, health and job creation (Wright et al. 1987). On this basis, Stonecash et.al.

[32] For a detailed review of the literature, please see Manza, Hout and Brooks (1995)

(2000) argued that lower and middle class Americans broadly support Democratic Party and the findings are consistent with class-voting hypothesis.

Class-voting hypothesis have been criticized both analytically and empirically in recent years. Examining the political change in Britain and how voters respond to these changes, Heath and colleagues (1991) found that many members of the particular class do not vote for their natural class party. Indeed, it has long been known that conservative workers associate themselves with Conservative Party, while a number of upper-middle class Brits align themselves with the Labor Party. In fact, the similar trends had been observed by a number of analysts claiming that influence of class in modern societies has weakened (Clark et.al., 1993) and replaced by a number of social cleavages on cultural and social issues (Inglehart, 1990). Following this broader trends in society and politics, other scholars have argued that such a change in values and preferences led to a general process of dealignment (Nie et.al., 1981). Such a change brought a new debate on the evolution of party coalitions and political alignments (Manza and Brooks, 1997; Manza et.al., 1995). Others stated that general decline in cleavage politics occurred in modern democracies, which earlier based on class-based cleavages (Frankin, 1992).

The social and cultural bases of political behavior and cleavages in the society (due to racial/ethnic, religious, gender etc.) have, therefore, appeared to the forefront of debates in capitalist democracies. A number of analysts attempted to explain the decline of class cleavage and the rise for new patterns of divisions in advanced industrial societies. Inglehart's theory of post-materialism provided the most solid

account of cultural change and in advanced industrial societies (Layman and Carmines, 1997). Inglehart (1971, 1977, 1981, 1990) and also Inglehart and Abramson (1994) argued that basic values of Western societies has altered in recent years leading a serious change in political agenda, party alignment and political behavior. Post-materialist values of advanced societies, in Inglehart's perspective, prevailed over the materialist debates over 'bread and butter' issues of 19th and 20th century politics. Others have stressed the centrality of growth in professional and managerial classes and macro level changes in the organization of national economies, under the influence of global competition over organized capitalism (Lash and Urry, 1987) or embedded liberalism (Ruggie, 1982) and effects over social democratic parties and movements (Offe, 1992).

Even though the explanations have varied in terms of the reasons for the decay of class-based politics in advanced capitalist societies, almost all of the analysts emphasized the new and emerging role of social and cultural values. In the light of this analysis, the following part will examine the role of religious traditionalism –one may call it either moral values or conservatism- and racial issues in American politics. The central objective of this analysis is to show that class (economic interest) is not the only determinant of political behavior in the US. In this respect, any analysis that assumes a high congruence between class (income groups) and their political preferences would be inadequate to capture the complex dynamics of political behavior and policy outcomes in the US in the last three decades. Such an analysis, thus, is expected to yield positive results in terms of identifying other factors shaping interests and political preferences of American voter.

4.3.1. Religious Traditionalism and Moral Issues in American Politics

Religion has always been an important element of American politics. In this respect, the US clearly differentiated from the secular regimes of capitalist democracies in Western Europe (Manza and Brooks, 1997). Lipset (1996), for example, discussed how Americans differentiate from other nations particularly emphasizing the influence of religious and moral values in the American society. These analyses indicated that even though the US is the most secular country in terms of a formal separation of state and church (Fox and Sandler, 2005; Fox, 2006), it has been recognized that Americans remain religious despite their advanced level of economic development (Wald, 1992). Hence, religion traditionally has exerted a considerable influence on political culture and policy coalitions in the US (Layman and Carmines, 1997: 752; Wald, 1992).

Religious cleavages, therefore, shaped the party alignment and political behavior of American electorate throughout the 20th century. Rose and Unwin (1969) has argued that religious based cleavages may have been a more important factor in order to understand the social bases of voter alignment than class cleavage. Their point is much more striking remembering that they made the point long before scholars stressed the decline of class politics in the advanced capitalist nations. Whether their thesis is consistent with the political behavior of Americans in the 1960s or not, their emphasis on the centrality of religion in American politics reflects a consensus in the literature. Manza and Brooks (1997: 39) also confirm that “despite expectations that

the New Deal political realignment in the 1930s would lead to a pattern of electoral alignments dominated by class, the political significance of religious cleavages has proved to be resilient throughout the 20th century". In this regard, one can argue that religion had always been an important factor in American politics in shaping attitudes, preferences and party alignments.

Alongside the continuous impact of religion in American politics, a number of studies recognized that the importance of religion has considerably increased in American politics since the 1970s. Indeed, these new strand of studies (Diamond, 1995; Himmelstein, 1990; Guth, 1983; Guth et.al., 1988; Jelen, 1991) was an outcome of a reviving interest to the study of religion and politics in American society. Interestingly, this revival has been mostly coincided with the emergence of 'Christian Right' in the US. These studies examined how Christian Right politicized certain aspects and core values of religion, and enabled religious conservatives to participate into political process with clear-cut preferences on certain moral and religious issues (Manza and Brooks, 1997; Diamond, 1995). Threatened with the liberal environment and some of the Supreme Court decisions in the late 1960s and 1970s, religious conservatives mobilized themselves politically in order to eliminate pressure for further liberalization in social and cultural issues (Layman and Carmines, 1997: 753; Guth, 1983; Jelen, 1991).

Political mobilization of the Christian Right brought social and cultural issues at the forefront of American politics. In recent years, abortion, pornography, sex education, gay rights, right to die, and capital punishment have been widely discussed in the

public and dominated the political realm. According to Mooney (2000), the widespread discussion and public involvement in these debates not only reflected evident rise and political mobilization of conservatism in the US, but also it was due to the nature of these policies. Mooney argues that 'morality policies' tend to be technically simple, potentially salient to general public and involve higher level of policy-making. Therefore, policymakers should be much more responsive to citizen's values in this type of policies (2000: 174-6). [33]As a result, there has been an intense and continuing policymaking activity in recent years. Mooney (2000) reports the controversial policymaking processes of gambling related offenses in Louisiana, acceptance of gay marriage in Vermont, and censoring of sex and violence on video games in Oregon. Obviously, as seen in the Vermont case, not always Christian Right has been able to win the policy battles. Yet, the social and cultural agenda pushing religious traditionalism shaped American politics in recent years.

These cultural differences represented itself in the American political behavior. Langer and Cohen (2005) reports that 2004 National Election Pool (NEP) exit poll indicated the centrality of moral concerns in American political behavior. According to this poll, 22% of respondents revealed that moral values are the 'one issue mattered most in deciding how [they] voted for President' (2005: 746). These results show that moral values ranked first among a number of core issues in American

[33] The issue of non-technicality, saliency and public involvement of political issues are particularly important in explaining the issues that I discussed in the second part of this chapter. In the public opinion part, I have argued that most of the political issues are technical and most of the citizens do not have certain knowledge of it. However, moral policies are not that type of policies.

society.[34] Also Pew Research Center (2004 quoted in Langer and Cohen 2004) survey asked respondents, who cited moral values as an important issue in their vote, what brought to their mind in thinking moral values (Langer and Cohen: 746). Gay marriage (29%) and abortion (28%) were the most favored answers, followed by religious beliefs (18%), honesty or integrity (9%). The data indicate and evidence strong presence of moral values shaping political attitudes of electorate in American politics.

The changes in the political behavior of citizens also reflected itself in the party alignments. It has been long recognized that mainline Protestant sects generally remained solidly Republican in their preferences (Fowler and Hertzke, 1995). What Manza and Brooks (1997) found empirically is that denominationally conservative Protestants realigned with the Republican Party and increased their level of participation in presidential elections. This empirical finding is consistent with the argument that political mobilization of the Christian Right in the 1980s has been transmitted into political realm through Republican Party (Knuckey, 2005). In this regard, it has been recognized that since 1980s, the two major political parties in the US have become increasingly polarized on social and cultural issues (Layman and Carmines, 1997: 752). As such, Republicans turned into the political home of religious traditionalists, whereas Democratic Party represented secularists and religious liberals.

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[34] Moral values attracted more attention from respondents in their decision over President. Economy/jobs 20%, Terrorism 19%, Iraq 15% and Health Care 8%. The details can be found in Langer and Cohen (2005: 746)

The growing importance of these issues made itself apparently evident in the 1992 presidential election (Knuckey, 2005). On this issue, Kaufmann (2002) argued that Democrats were not different in 1992 elections in economic terms with their conservative fiscal and monetary policy agenda. However, the real difference between these two parties demonstrated itself in the realm of social and cultural issues, in particular on abortion issue (Abramowitz, 1995). In a similar vein, White (2002) and Erikson (2001) observed that social and cultural difference between political parties widened throughout the Clinton administration. Both of these accounts indicated how religious and moral values affect political behavior of Americans and how they shape party alignments and policy outcomes.

4.3.2. Racial Issues in American Politics

Racial issues have been an enduring aspect of American politics. Historically, American social and political institutions have been characterized with white supremacy. Non-whites have been viewed as inferior for many years. In this respect, King and Smith (2005: 75) argue that American society can be conceptualized with the concept of 'racial institutional order', which they state that "racial orders are ones in which political actors have adopted racial concepts, commitments and aims in order to help bind together their coalitions and structure governing institutions that express and serve the interests of the architects". In their framework, since the foundation, political coalition of Americans secured white supremacy in most of the governing institutions (economic, legal, educational etc.). Obviously, such a racial order was not always consistent and indeed it was challenged by a 'transformative

egalitarian order' especially since the Civil Rights Movements of 1960s. Nevertheless, white supremacy has been institutionalized in the Congress, bureaucracy and many policy areas. For example in bureaucracy, African-Americans were discriminated in hiring practices and confined to low-level positions. Or, federal departments helped to implement and monitor segregationist order between 1896 and 1954 under the rubric of 'separate but equal' policies (King and Smith, 2005; King, 1995). These qualitative and historical evidences points out the existence of a racial structure in American politics.

Structured white supremacy in American politics can be supported by the quantitative evidence as well. Even though the American society elected Barack H. Obama as its first African-American president, the figures indicate that black representation in American politics have been a rare issue (Hutchings and Valentino, 2004). Walton and Smith (2001) states that only four blacks have ever served in the US Senate in the entire history of the nation (quoted in Hutchings and Valentino, 2004: 385). This case is much more prevalent in white-majority districts. For instance, Canon (1999) reports that in the 6667 House elections between 1966 and 1996 in white-majority districts, only 35 (0.52%) were won by blacks. These findings show that white prejudice over African-Americans seems to be an enduring feature of American politics and keep on shaping political preferences.

On the other hand, at first sight, these findings seem to be inconsistent with the survey results on white attitudes towards blacks. Krysan (2000: 137-8) states that survey data report a significant liberalization over the past decades in terms of racial

attitudes. However, she also points out that this change is inconsistent with the qualitative evidence on persistence of prejudice, discrimination and racial inequality. Hence, she argues that present racial climate in the US create “social desirability pressures [operating] to suppress self-reports of negative racial attitudes” (2000: 138). The persistent but changing nature of racial prejudice has been explained by a group of theorists on the basis that Civil Rights Movements of 1960s diluted the effect of ‘old-fashioned racism’ that supports biological inferiority of racial minorities (Schuman et.al, 1997; Hutchings and Valentino, 2004). This old type of racism has been replaced by a new type (symbolic racism or modern racism) stressing certain beliefs that blacks were no longer discriminated, that their failure in social mobility stems from their unwillingness to work and they rely too much on government (Kinder and Sanders, 1996; Sears et.al., 2000; Gilens, 1995). The observable implications of this new stance can also be founded in the political campaigns. In order not be labeled as racists, candidates refrain to use explicit racial language, but instead they used ‘coded language’ stressing the prejudices and values of white supremacy over non-whites (Mendelberg, 2001). All of these studies confirmed the enduring relevance of racial issues in American politics, even though the nature (maybe façade) of relations has changed remarkably.

Racial attitudes and racial origin shapes political preferences of American voter. This hypothesis has been tested in a number of studies examining the role of racial attitudes towards voting and policy preferences. For example, Terkildsen (1993) found that white voters are more likely to support the white candidate, ceteris paribus –all other factors hold equal. This analysis does not only indicate the persistence of

prejudice but also shows how such a prejudice affects political preferences of white electorate. Kinder and Winter (2001) also provide evidence for the racial gap in public opinion over certain political preferences. To them, blacks and white differ in their stances toward race-targeted policies as affirmative action policies, school desegration and black-assistance policies. There are huge differences on attitudes toward government spending on education and health, as well as differences on certain values such as egalitarianism, size of government, and fairness of American political system.

In line with the previous studies, Gilens (1995) examined the influence of racial attitudes on welfare policy attitudes. Unlike the welfare state literature that stressed the centrality of economic self-interest, individualism and egalitarianism; Gilens argued that the stereotype of 'blacks as lazy' as a traditional prejudice is widespread among whites and have a profound impact on welfare attitudes of white individuals. He (1995: 995-6) also, interestingly, observed that "Americans almost unanimously support programs that require previous contribution… and favor groups such as elderly or the infirm [those programs that would most likely help whites]…but when it comes to means-tested programs that provide benefits to the needy [those likely to help blacks]" they have completely different preferences over welfare policies. Gilens' (1995) analysis provides a solid and rigorous ground to see the effect of racial attitudes on welfare preferences. But much more importantly, Gilens shows that the typical American who most likely favors welfare policies (in line with their economic self-interest) might oppose these policies due to its racial preferences.

Such a valuable observation may yield us to extrapolate on how economic and non-economic interests might clash, and how individuals prefer the latter.

Having a great impact on political preferences of individuals, racial attitudes also shaped party politics in the US especially after the Civil Rights Movements of 1960s. It has been recognized by students of race in the US that large majority of African Americans supported Democrats. This support grew further after the 1960s, with the polarization of political parties on racial issues (Hutching and Valentino, 2004: 386-7).[35] A number of observable implications can be counted: partisan identification towards Democrats among the African American community has doubled in the 1960s (Miller and Hanks, 1996), while only 44% of white associate themselves with Democrats in the 2000 elections, 82% of blacks identified themselves as a supporter of Democratic Party (Abramson, et.al., 2003), similarly only 8% of blacks supported George W. Bush whereas 54% of whites did so. Last but not least, Walton (1985) showed that pluralities of whites have supported Republicans in 10 out of 1 presidential elections since 1960 (cited in Hutching and Valentino, 2004: 387).

These facts clearly confirms the hypothesis that following the 1960s, with the polarization of racial and cultural issues, while African-Americans tended to vote for Democrats, whites preferred Republicans due to racial reasons.[36] These trends in political behavior and party identification signified a changing composition (re-alignment) in the social bases of Republicans and Democrats. Especially, the

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[35] The following review and evidence are mostly based on Hutchings and Valentino (2004)

[36] Obviously, racial concerns were not the only factor in the changing preferences of white voter. I focused on the morality policy but one can also discuss national defense, welfare spending and less intrusive government as well.

Democratic support in the South has dropped significantly among white population (Petrocik, 1987; Frymer, 1999; Miller and Shanks, 1996). Indeed, South has preferred Democrats 'solidly' from the end of Reconstruction to the 1960s (Hutching and Valentino, 2004). However, the pressure of Civil Rights Movement and struggle over race accelerated the realignment of southern whites into the Republican camps.

4.3.3. Remarkable Observations, Crucial Insights

Our analysis on the non-material (social and cultural) factors targeted to understand the limits of economic self-interest and class-voting. Since my third assumption rested on the idea that individuals are expected to follow their economic interests and should have political preferences alongside their class positions, the prevalence of non-economic concerns of American voter would have a vital importance for a healthy analysis. Let me briefly summarize the important findings and conclusions of the aforementioned discussion.

First of all, I identified the extent to which American voters' political preferences can be identified with its class position. Recent scholarship on the issue has rather emphasized the social and cultural factors in order to explain the variance in the policy preferences. New cleavages in the society have brought new issues into the forefront of politics and 'bread and butter' issues became rather peripheral in the last decades.

Secondly, I introduced moral concerns as one of the major issues in American

politics, which has a profound impact in political preferences and party alignment. I showed that liberal environment of the late 1960s challenged the traditional values of most Americans. Christian Right and religiously conservatives responded to this environment through more political mobilization. The Republican Party was able to channel their interest and appeal to culturally conservative electorate. As such, issues as abortion, gay marriage, pornography and sex education came into the forefront of politics. Also, the observation of Mooney (2000) that policymakers are highly responsive to the public opinion on matters of morality policies since these issues are mostly non-technical, salient and involve broader public into the debate, needs particular attention for the further analysis. As I discussed in the previous part, one of the drawbacks of democratic responsiveness rests on the fact that public is generally either uniformed about the technical nature of policies or uninterested about them. This shows that nature of policy might be an explanatory factor in discussing the limitations of democratic responsiveness in other issues, particularly finance for our purposes.

Thirdly, based on extensive review of the literature, I argued that race is a persistent feature of American politics. It affects political preferences of whites and blacks, as well as shapes their party alignments. The data clearly indicate that most of blacks associate themselves with the Democratic Party, whereas majority of the whites go for the Republicans. I also discussed how Civil Rights Movements of 1960s both extended political and civil rights of racial minorities, but on the other hand, polarized political preferences of whites and blacks. Another interesting observation that might yield fruitful insights for our analysis has been provided by Gilens (1995)

on the relationship between racial attitudes and welfare preferences. Gilens showed that most of white individuals oppose welfare spending due to racial concerns, even if its economic interests lead them to support these policies. This finding is valuable in the sense that it clearly shows that lower and middle-class white Americans might prevail their racial concerns over their economic interests. Extension of this observation upon new data is crucial.

Last but not least, the analysis showed that both material and cultural factors should be taken into account in the examination of political behavior in the US. Even though, moral an racial issues came to the forefront of politics in the US particularly in course of last three decades, empirical evidence shows how lower class mobilization can influence political outcomes. In this respect, I pay particular attention not to exaggerate the impact of cultural factors in American politics. Furthermore, the interaction of material and cultural dynamics should not be overlooked. A number of studies has shown how blacks are represented as poor in the media and emphasized the racialization of class. In this light, the influence of non-material factors will be examined in conjunction with material interests.

4.4. A New Perspective: Rational Model for the Financial Deregulation

The objective of this chapter is to solve an interesting paradox in American politics: Over the last thirty years, most of the supporters of the economic conservatism (neo-liberalism in the continental sense) carried out their political and economic agenda. These policies targeted to reduce corporate and income taxes, reduce welfare

spending, deregulate markets and remove governmental supervision in variety of sectors (banking, energy and transportation), as well push further liberalization in trade and finance. At the same time, the data show that the outcome of these policies for the majority of the citizens have been stagnant wages, deteriorating income equality and rising poverty. Focusing on the changes in the finance realm, I asked why people agreed –or at least tacitly consented- on a policy paradigm that has worked in contrast to their interests. Normally, one would expect resentment to the policies that deteriorated income in a democratic system, where public has decisive power, individuals are rational and pursue their economic self-interest. However, the outcome was inconsistent with the expectations.

4.4.1. A Brief Review

I started with challenging the assumptions I made at the initial stage and tried to re-define them with the help of existing literature. Table 4.1 briefly summarizes the initial assumptions, different stances in the literature and the major findings in terms of political behavior of American electorate. On this basis I intended to clarify the explanatory variables in order to provide a stepping stone and giving a plausible answer to the paradox.

My first assumption rested on the idea that democracies are and should be responsive to the demands, opinion and values of the electorate. In this view, policy-makers should be responsive to the demands, opinion and values of the electorate not necessarily because they are honest or altruistic. However, they still should be

responsive since their main incentive is to be re-elected and the electorate will decide if the policy-maker will be or not. However, it is evident that dynamics of party politics and centrality of large and costly political campaigns hamper democratic responsiveness. The ability to remain in the office or to be re-elected is not only a function to appeal to the broader electorate but also to secure donation from wealthy donors and have a position in party hierarchy. For these reasons, a number of elite dominance theorists argued that economic elites and/or upper social classes have an indispensable power in shaping political outcomes. However, the quantitative evidence does not support such a thesis. Instead, many major studies confirmed the relevancy of public opinion on a number of issues. Yet, these studies warned that there is still room for elite role in public opinion shaping and on technical and non-salient issues. In the light of this analysis I refine the first hypothesis stating that both elite influence and public opinion matters in democracies. It is impossible to see neither perfect responsiveness nor elite domination. Thus, I come with an explanatory variable which I call *level of democratic responsiveness*. This variable indicates the degree to which policy-makers are responsiveness to the demands of citizens. In other words, it measures the congruence between public opinion and policy outcome.

Table 4.1. Stylized Facts

	Assumptions	**Alternative Scenarios**	**Results of Analysis / Refining Assumptions**	**Explanatory Variables**
Responsiveness	Democracies are and should	a. *Elite dominance*: Elites have an	a. Both elites and public opinion matters. The	*Level of democratic*

	be responsive to the demands, opinion and values of the electorate.	indispensable power to influence political outcomes b. *Public Opinion Responsiveness*: The main incentive of the policymakers is to be reelected. Hence, they should rely on public opinion to achieve this.	ability of elites directly influencing political outcomes is limited. b. Democratic responsiveness varies on the basis of issues. Technical and non-salient issues are more likely to be shaped by the elites.	*responsiveness:* the extent to which policy-makers are responsive to the opinion, values and demands of the public. It is the congruence between public opinion and policy outcomes.
Rationality and Informed Preferences	Individuals are *rational* and *informed* about their preferences, interests and what policies would serve to their interests. Rationality, here, simply refers to the ordering of preferences.	a. People are rational and informed about politics. b. People are rational but their rationality is bounded with certain constraints. That partly stems from the fact that people usually are uninformed about most of the technicalities of the issues. c. People are irrational and uninformed about their preferences, interests; and do not	a. Rationality of individuals are bounded specifically due to information constraints. People usually do not have concrete knowledge about the technical details of policies. Therefore, their preferences are unhealthy and they have biased knowledge of what policies would serve to their interests. b. Elites usually exploit their mobilization power to influence public	a. *Level of issue saliency*: the level of public knowledge and visibility on a certain policy. b. *Elite influence in shaping public opinion*: the level of elite influence in shaping public opinion on certain policy.

		have any idea what policies would serve to their interests.	opinion. This is where elites influence the political outcomes most.	
Economic/Class-Voting	a. Individuals are expected to follow their economic self-interest. b. There should be congruence between the class positions of individuals and their political preferences on economic issues.	a. Economic/Class-voting theories assert that economic interest and the class position are the major factors explaining the variance in political behavior and policy preference. b. Non-economic (social and cultural) factors better explain political behavior of the electorate in advanced democracies. Moral and racial issues are particularly crucial in American politics and they have profound effect on the political behavior of the American electorate.	a. Non-economic factors have a profound effect on political behavior of American electorate. b. Moral and racial issues better explain the political behavior of white middle and lower class Americans. Majority of whites prefer Republican Party. c. This preference indicates that even if it is inconsistent with their initial economic preferences, social and cultural preferences of middle and lower class white electorate prevail overt their economic preferences.	*Level of Class-based voting*: the congruence between class position and policy preferences.

The second dimension of the analysis rested on the assumption that individuals are rational and informed about politics. Rationality in my analysis is simply the ability

of ordering preferences in a consistent manner. For example if preference A is better than preference B for individual X, and preference B is better than C for the same individual X, then one normally expect individual X to prefer A over C. On the other hand, my analysis identified to what extent individuals are informed about their political preferences, policy options and the expected outcome of various policy options in terms of their interests. The analysis indicated that in most of the issues people are either uninformed about the technical nature of policies or unconcerned. The elites have , therefore, much more power to shape public opinion and policy outcome in technical issues. However, people are likely to be much more concerned with non-technical and salient issues such as morality or racial policies. In this respect, saliency of the issue is a critical factor in determining how public is informed about their preferences and how much elites can influence their opinion.

Last but not least, I considered the hypothesis that people follow their economic self-interest and there should be congruence between their class positions and policy preferences. However, the recent scholarship indicated that social and cultural issues are more likely to shape political behavior in advanced democracies. The analysis indicated that moral and racial issues have a profound impact over political preferences of American voter. The analysis on the influence of racial attitudes on welfare policy preferences showed that even if the initial preferences of white electorate have been in favor welfare, they oppose welfare arrangements on the basis these policies target ‘lazy blacks’. On this basis, I argue that middle and lower class white Americans are likely to abandon their welfare preferences for the sake of their racial attitudes.

4.4.2. Toward an Explanation

In the following, I try to simply model the preferences of upper and lower-middle class Americans on economic issues and non-economic issues. I divide the classes into two categories: upper classes and lower-middle classes. Obviously, such a stylized model has certain shortcomings. First of all, it is hard to identify classes as unified blocs with definite interests and objectives. Similarly, I do not take the party identification into account and simple consider Democrat and Republican supporters in the same basket. Thirdly, I combine lower and middle class Americans due to the reason that they are both affected from the deterioration of income distribution in the last three decades. However, it is certain that they might have slightly different political preferences that may affect the analysis.

Table 4.2 indicates the political preferences of different classes on economic issues such as welfare and finance, as well on non-economic issues (social and cultural issues) focusing on moral and racial issues. Upper classes have a certain interest in keeping welfare spending low. They are aware of the fact that higher taxation is required in order to finance larger welfare arrangements. It is also evident that welfare policies target poor, needy and the lower classes. Hence, supporting welfare policies would be paying a meal that will never be eaten. Their support to welfare policies, therefore, has been low. In contrast, upper classes supported financial liberalization, deregulation and innovation. I have widely discussed how financial liberalization brought prosperity to a minority of Americans and deteriorated the income distribution.

The preferences of upper classes on non-economic issues are much more complex and needs more elaboration. Jenkins and Eckert (2000: 311-2) argues that there are three business (upper class) coalitions. Two of them places themselves in the right and have been associated with the Republican Party in an increasing manner since the 1980s. Moderate conservatives (highly associated with Business Roundtable and American Enterprise Institute) have a much more modest stance in moral issues compared to ultraconservatives (Heritage Foundation, Hoover Institution, National Association of Manufacturers etc.). On the 'corporate liberals' aligned with the Democrats and supported a much more liberal agenda. Burris (1987) and Salt (1989) found that corporate elites have much more moderate stance on moral issues, but Midwestern manufacturers and less capital intensive firms are more likely to support ultraconservative position. I accept that the total effect of all these diverse views culminated with a modest stance in moral issues. On the racial attitudes side, similar divisions can be traced among business and corporate groups, also in the upper class. However, one should also remind how racial order has been institutionalized in American politics as King and Smith (2005) theorized and how such a racial division has been an enduring feature of social and political life. Therefore, I assign a 'medium-high' value for the upper class preference for racial issues.

Table 4.2. Expected Class Preferences on Policy Issues

	Economic Issues		Non-Economic Issues	
	Welfare	**Finance**	**Moral**	**Race**
Upper Class Preferences	Low	High	Medium	Medium-High
Lower and Middle Class Preferences	High	Low-Medium	High	High
Expected Outcome	Medium	Medium	Medium-High	Medium-High
Real outcome	Low-Medium	High	Medium-High	Medium-High

Lower and middle class preferences on non-economic issues are much more consistent than the economic ones. I have earlier provided evidence for how large majority of Americans define moral issues as their central concern in their political decisions. Similarly, large majority of Americans keeps their racial prejudice toward non-whites and these racial attitudes affect their political preferences on other policy realms. On the welfare preferences of Americans, Gilens (1995) argues that the large majority support welfare in its broader meaning. This is also consistent with the economic self-interest explanation that lower and middle classes are expected to support these policies. On the finance side, the issue is more complicated. The broader outcome demonstrates that financial liberalization deteriorated the income inequality. Hence, it is expected that lower and middle class Americans would oppose financial liberalization. But on the other hand, it is plausible that financial

expansion stimulated economy and increased the opportunity to spend more. The expected outcome and reality is only consistent in the non-economic issues. However, the preference model expects that welfare spending should have been more and there would have been lesser financial liberalization.

This analysis do not answer to solve the puzzle but confirms the paradoxical nature in amore solid and rigorous way. On the other hand, I will try to provide a plausible answer based on the explanatory variables that I discussed above. These variables are level democratic responsiveness, issue saliency, elite influence on public opinion and class-based voting. I discuss the relevancy of these issues on welfare and financial policy attitudes. Table 4.3. summarizes the arguments.

The discussion on the welfare policy indicated that even though large majority of middle and lower class Americans are aware of the fact that supporting welfare measures are mostly consistent with their economic self-interest, they opposed on the racial grounds. From this observation, I can identify that class-voting dimension is low but issue saliency is medium-high. Accepting that the majority have an ambivalent attitude towards welfare, we can accept that policy is at least at the medium level is consistent with the public opinion. Nevertheless, elites are influential in the sense that they shaped public opinion associating black image with poverty, idleness and over reliance on government. The public image of welfare policies, thus, has been based on a biased image that welfare policies only target blacks and do not appeal to broader concerns of American society such as rising poverty, inequality and social problems. Therefore, I argue that, the major

explanatory power rests on the level of class-voting variable. Majority of Americans cared their racial attitudes much more than their economic or class interest. Obviously, elites manipulated the public opinion associating non-whites with welfare arrangements.

Table. 4.3. Simple Bargaining/Coalition Model

	Welfare	**Finance 1**	**Finance 2**
Democratic Responsiveness	Medium	Low	Medium
Issue Saliency	Medium-High	Low	Medium
Elite Influence on Public Opinion	Medium-High	High	Medium-High
Class-based Voting	Low-Medium	Low	Medium-High

For the explanation of finance, I provide to alternative scenarios. In the first model, democratic responsiveness is weak. Elites are powerful enough to shape policy outcomes. The technicality of issues also makes public less interested in financial issues. In parallel, the ideological orientation (free-market mantra) and public opinion shaping through experts and media convinced people that finance would likely to bring prosperity to the nation and create a much more competitive economy. These factors have been also supported with the explanations that I put forth for non-economic factors. The reasons explain why most of the Americans have voted for the Republican governments, which were not their economic policy preferences but their

concern for moral and racial issues. Indeed, many analysts depicted the realignment of the 1980s in the Republican Party as the coalition of corporate elite, conservative upper class and Christian Right (Domhoff, 2006; Jenkins and Eckert, 2000; Ferguson and Roger, 1986). This coalition hypothesis is consistent with this scenario in the sense that Christian Right achieved what they want (morality policy) and upper class (corporate elite) achieved further economic liberalization. However this model is based on the simple assumptions that I made and criticized on elite dominance with respect to democratic responsiveness.

The second scenario on finance slightly differs from the first model in the sense that it is consistent with the refined assumptions. First of all, in this model, individuals are much more informed about their preferences although do not have clear-cut idea on financial liberalization. They are less influenced with the idea that finance would likely to bring prosperity in the future. Instead, they are rational actors who are aware of the fact that their ability to shape political outcomes are confined with the elite's influence over policymaking but not totally curbed, which is coherent with the first assumption. Much more importantly, they know that finance really brings 'artificial prosperity' in the short-run. As I stressed many times, the broader problem for the lower and middle class Americans have never been specifically certain economic policies but the outcome of them, namely stagnant wages, decreasing purchasing power and deteriorating income. In this respect, financial boom –expansion of financial markets with the innovation, derivative products- enabled lower and middle class Americans to spend well beyond their means. In other words, under the conditions of limited responsiveness, lower and middle class Americans sacrificed

their long-term objective of economic equality for the sake of short-term well-being and consumption to keep their purchasing power and compensate stagnant wages. Obviously, such an analysis does not disregard the effects of non-economic concerns. The choice of many white lower and middle class Americans have centered on moral and racial issues instead of a direct economic preference. Nevertheless, second model argues that there is a class and economic voting dynamic underneath. The reason why people tacitly agreed on a general liberalization process, which in the long run did not brought prosperity to them, stems from the fact that the long-term deteriorating effects of neo-liberalism had been curbed by the financial expansion in the short-run.

CONCLUSION

The present study examined the political origins of the recent financial crisis in the US and questioned how new financial system have been established on legal and institutional grounds in a democratic setting. The puzzling part of the problem stems from the negative impacts of unfettered finance on income equality and real wages alongside with other neo-liberal policies. I discussed the ways how it could have been politically feasible to institutionalize the current financial system that has negative impacts on income distribution, has systemic weaknesses and prone to crises. In other words, I examined what could have been the legitimate reason behind the wide approval and tacit consent of people over financial deregulation and innovation.

The role of politics has been frequently emphasized in the examination of the emergence of the recent financial crisis and the institutionalization of the existing financial system. I argued that the decisions towards the establishment of current financial system required intense political activity and had distributional outcomes. In this respect, I took a different position than the approaches grounded in neo-classical economics in the sense that I do not identify adopted policies and institutions as right economic measures. Instead, I focused on actors, interests and power relations, as well as role of ideas in the establishment of the existing financial system.

Following such an institutionalist insight, in chapter 2, I discussed how international monetary system, national financial regulation and the new financial system are interlinked. This analysis also showed how national and international level works in a dynamic fashion. I put forth that financial community had a vested interest in flexible exchange rates and the repeal of strict financial regulation. Indeed, New Deal reforms and Bretton Woods with fixed exchange rates, capital controls and narrow banking model restricted their ability to operate within across the borders. Hence, the major objective of the financial community is to relax Glass-Steagall Act since 1970s. They also encouraged and stimulated the collapse of Bretton Woods international monetary order with their political pressure and their off-shore operations in Euromarkets. They also utilized monetarist and neo-liberal ideas Milton Friedman and Friedrich Hayek to combat with Keynesian embedded liberalism.

The end of Bretton Woods system and the increasing influence of corporate business in consecutive Republican government provided the political basis of deregulation in financial realm in the 1980s. Chapter 2 provided a detailed account of financial deregulation in the US with an emphasis on geographical de-segmentation and relaxation of strict barriers to financial operations. The repeal of Glass-Steagall Act in 1999 was the last turning point in the liberal operation financial actors. All of these regulations had a major impact on the financial services industry in the US. The number of banks dropped and large conglomerates concentrated financial activities. These deregulations also allowed risky business with leverage and derivative

instruments. In this respect, the legal and institutional changes in the 1980s opened the ways to the new financial system.

The new financial system can be characterized with perverse incentives encouraging extreme risk-taking. The analysis in the second chapter showed how perverse incentives and lax regulation both allowed financial firms to enjoy high profits, not be able to keep out of bubble, as well how ordinary individuals joined the bubble through consumption and housing market. High profits made financial firms more willing to produce new financial instruments and to increase leverage to keep their balances out of regulatory framework. Extreme risk-taking and incentive to appeal sub-prime segments ignited the mortgage crisis and credit crunch of 2007.

Having analyzed the major changes in the financial realm, I focused on the distributional impacts of this major policy paradigm change. In this manner, in the third chapter, based on historical and empirical evidence I attempted to show that in the last thirty years income equality has deteriorated and real wages remain stagnant even though the stable economic growth has been maintained and productivity increased. This means, for the large part of the society, that their incomes remained mostly stagnant and their purchasing power either declined or stayed same as they were in thirty years ago. This observation constituted the backbone of the central puzzle of this thesis. How people could be convinced on a policy change that is likely to produce income inequality and stagnant wages? In other words, I examined

why broader segments of American society did not resent on this major policy change through democratic means.

The last chapter of the thesis aimed to provide a plausible answer to this democratic puzzle. As I emphasized frequently throughout the thesis, my prior objective has been to identify the political causes of the current financial system and the crisis. I stressed how the discussion on American democracy is an integral part of the debate on the current financial crisis. In order to give a plausible answer to the democratic puzzle I presented here, I defined democracy in a simple way to delineate a political regime, where individuals have right to influence political outcomes. In a sense, American democracy has been discussed as the major guiding rules of the game between individuals in American society, as well as the major structure to carry interests into the political system. To be more concrete, I assumed that democracies are responsive regimes; individuals are rational and informed about their decisions and interest; and people pursue their economic self-interest. The rest of the chapter focused on a careful de-construction of these simple assumptions based on an extensive literature review.

The literature on democratic responsiveness and elite theory indicated that the US democracy is not fully responsive to the demands of the public. Elites have a particular influence on the political system toward a number channels such as candidate selection by campaign contribution, lobbying in the Congress, and public opinion shaping. However, it is not the case they have full control of government and

the Congress as elite theorists argued. Other studies, in this manner, empirically showed that there is congruence between public opinion and polity outcomes. Therefore, the analysis on democratic responsiveness reveals only partial answer to the central question. If the results of this literature survey had indicated the idea that elites are able to shape political outcomes almost in every case, then I might have argued that financial deregulation have taken place in a artificial democratic environment, in which elites have the real power and public does not. However, the analysis indicated a balanced outcome, where both elites are influential in the political system of the US and broader public have ability to shape political outcomes. .

The second assumption was on rationality and information. I simple assumed that people are rational and informed about politics. However, studies have shown that people are usually not interested in politics, do not have clear knowledge of legislative process, hence, their preferences are not formed in an informed manner. In this respect, their rationality is bounded with information problems. Nevertheless, it does not mean that people are totally ignorant about politics and do not have concrete and well defined preferences. Instead, it was shown that some issues have greater public saliency than others. For example, moral and racial issues have greater public saliency in the US. In contrast, technical issues tend to appeal less people and have lower level of saliency. These technical issues are also the issues that elites have greater ability to shape public opinion through media and expertise knowledge. This analysis pointed out the necessity of a much more subtle examination of how issues

vary in terms of their saliency and to what extent elites can be successful in shaping public opinion.

Thirdly, I assumed that people should follow their economic interests. Therefore, there should be an identifiable congruence between the class and/or income position of an individual and his/her political behavior. However, my analysis put forth that moral and racial issues do have a greater saliency and importance in shaping political outcomes and political behavior in elections. The polls in 2004 showed that morality issues were the major factor in shaping electorate decision in choosing the president. In this manner, the role of moral and racial issues in shaping behavior of US electorate has been mostly appreciated in the literature. Nonetheless, others stressed how lower class mobilization or labor unions can be effective in social policy outcomes. These studies empirically showed that class dimension of American politics should not be overlooked.

Deconstruction of these assumptions provided a strong framework to discuss the institutionalization of finance in the US. The answer and insights obtained from this analysis were remarkable. Elites, particularly financial community, were effective in the institutionalization of the new financial architecture with their ability to influence political outcomes in the Congress and in state institutions. Furthermore, financial issues are mostly technical and elites had opportunity to shape public opinion convincing the broader masses that financial openness would bring prosperity to everyone. Also, centrality of moral and racial issues led many low and middle

income white American to prefer the Republican Party and to have negative attitudes toward welfare spending and similar type of policies. I argued that these were relevant arguments and had a crucial impact on the emergence of the new financial system. Yet, confining the extents of analysis to these three dimensions would have provided an inadequate account of what happened in the US in recent years. On this basis, I presented an equilibrium/bargaining model that emphasize how financial deregulation and innovation created perverse incentives and altered the preferences of lower and middle class Americans.

In the model that I presented, long-term economic preferences of low and middle class Americans are defined as if they all simply support income equality and real wage/income increases. These groups are represented with conservative racial and moral preferences. In this model, individuals are aware of their limited capacity to influence outcomes even in a democratic setting. In other words, they know that democratic responsiveness is bounded with elite influence. And, even though they are rational, their interest and knowledge about politics is limited. They do not know the details of legislations on financial deregulation. However, they are able to identify long term impacts of political choices on their income, wages and life standards.

The model stresses the role of financial expansion in providing artifical wealth effect to broader segments of society and how such an effect brought legitimacy to major policy paradigm change. Hence, the model gives a plausible answer to the major

democratic and legitimacy puzzle o how current financial system could be institutionalized even though it had negative impacts to greater segments of society. I assert that in the short run, cheap and available credit options provided by the financial derivatives enabled low and middle class Americans to compensate their long-term losses in terms of real wages and income equality. Excessive borrowing helped them to keep their historically standard of living and continue their consumption to satisfy short-term needs. On this basis, I argue that large majority of the US population traded-off income equality and stagnant wages in return for their short-term benefits of keeping their standard of living through consumption. To the extent that they were able to consume as in the past, there was no solid reason to resist policy paradigm change. Furthermore, their incapacity to follow the technicalities of financial legislation hampered the public debate about these political changes. On the other hand, political parties realigned across cultural issues and the preferences of the electorate on moral and racial issues are satisfied as well as a part of democratic responsiveness. Combining all of these limitations and incentives, the model I presented asserts that low and middle class Americans did not resist the institutionalization of a new financial system even though it had negative impacts on their long term economic preferences.

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