

**Explaining the Economic Crisis:  
Can Political Scientists Contribute Anything that Journalists and Pundits Don't Know  
Already (and Can the Crisis Help Us Understand Political Science Theories)?**

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25<sup>th</sup> March 2010

**Abstract**

In capitalist systems, markets and private property provide the building blocks of economic activity. A major task for policymakers is to contain moral hazard by regulating markets in such a way as to prevent 'prodigals and projectors' (Adam Smith) from running the system into the ground through over speculation. In this task, governments of all advanced capitalist democracies have failed spectacularly over the course of the past quarter century or so. Political science offers a host of explanations for this. A first approach focuses on lobbying by financial actors aimed at coaxing governments into forgoing necessary regulation. Secondly, theories of elite integration emphasize how regulators and the regulated form common perspectives on policy. Thirdly, a neo-liberal ideology of unfettered markets and deregulation is said to have dominated political discourse and action since the 1970s, leading policymakers around the world to rely unduly on the ability of markets to correct themselves. A fourth argument points to the role of mass preferences in Western democracies:, highlighting how voters have consistently returned parties to office whose policies promised home ownership for everyone and never-ending increases in personal wealth and consumption, thereby inflating the bubble that eventually burst. Fifth, theories of structural state dependence focus on the ability of thriving financial markets in providing tax revenues and electoral support for governments in capitalist democracies. Sixth, institutionalist theories such as the varieties of capitalism literature would suggest that the crisis has both been generated in the context of liberal market economies and that it has affected liberal market democracies more severely than coordinated market economies. The paper identifies the potential contributions .of these different theoretical perspectives to our understanding of the root causes of the current crisis. It also outlines what lessons, if any, can be drawn from the crisis for major political science theories.

Prepared for the 60<sup>th</sup> Political Studies Association Annual Conference, 29 March - 1 April 2010, Edinburgh, UK. I thank Raj Chari, Richard Rose and the participants at the University of Glasgow's Department of Politics seminar on 15<sup>th</sup> March 2010 for inspiring conversations on the initial ideas for this paper were discussed.

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Already (and Can the Crisis Help Us Understand Political Science Theories)?**

In capitalist systems, markets and private property provide the building blocks of economic activity. The extent and mode of these institutions are shaped by policymakers with the political authority to grant, respect and protect these rights and provide institutions for judicial arbitration between claimants. A major task for policymakers is to contain moral hazard by regulating markets in such a way as to prevent 'prodigals and projectors' (Adam Smith) from running the system into the ground through over speculation.<sup>1</sup> In this task, governments of all advanced capitalist democracies have failed spectacularly over the course of the past quarter century or so. As moral hazard increased through the spread of secondary markets involving derivatives and other, increasingly complex financial instruments, so did the need for adequate regulation and supervision. But rather than providing this regulation, policymakers stood idle at best and at worst weakened existing regulation, thereby contributing to the development of speculative bubbles across several markets that eventually burst, leading to a financial and, ultimately, global economic crisis. The overly exposed Irish economy is just an extreme example of this development: after more than a decade of astonishing growth, Ireland became the first country in the Euro zone to officially slide into recession.

Why did policymakers (fail to) act the way they did? As this question is about political actors and their decisions, one would expect political scientists to have a lot to offer. But the first thing to note when looking for explanations in the political science literature is that there are very few. And where political scientists have attempted to make sense of the crisis and its political causes and consequences, they have done so largely without reaching very deeply into the conceptual and analytical toolbox of their discipline. Instead, they have joined economists, historians, journalists, and other experts on their respective turf. Often, these analyses are of very high quality and do certainly not need to hide behind the contributions

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<sup>1</sup> Adam Smith used these terms to refer to people willing to take excessive risk when discussing national interest rate setting: 'If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten per cent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest' (*The Wealth of Nations*, London: Dent, 1910 [1776], pp. 339-40).

from other academic disciplines and public commentary.<sup>2</sup> But they also tend to confine themselves to accounts of *how* the crisis unfolded rather than explanations for *why* it did. Even the best treatments by political scientists to date interpret the crisis more than explaining it with the use of political science theories (e.g. Gamble 2010) Rather than trying to explain the crisis with reference to the discipline's diverse repertoire of nomothetic explanations, idiographic story-telling prevails. Given the exceptional dimension of the latest financial and economic crisis, it one can understand this tendency toward historical analysis. But good theories should have sufficient explanatory leverage to account for events that are somewhat out of the ordinary.

Secondly, the bulk of recent writing on the crisis focuses on its economic, political and social implications and discusses political efforts to revive economic and financial activity while trying to prevent setting things up for the next crisis. While these efforts are necessary, they may be jumping the gun unless the root causes of the latest crisis have been sufficiently understood. It is the purpose of the present paper to probe the extent to which that task has been achieved.

### **In a Nutshell: The Unfolding of 2008-10 Financial Crisis**

#### *What happened?*

While different accounts exist of what caused the crisis, commentators have noted considerable agreement on the main events that marked the unfolding of the crisis. Thus, in order to provide the necessary background for an analysis of the causes of the crisis, a concise summary of the events will be provided, drawing closely on Gamble (2009).<sup>3</sup> In the spring of 2007, investment banks and mortgage lenders involved in the sub-prime housing markets in the USA began to experience difficulties from defaulting homeowners struggling in the face of increasing interest rates. Gradually, financial institutions began to realise just how much bad debt they were potentially carrying and how overextended they were. In the UK, this became obvious in September 2007 when Northern Rock experienced market-liquidity failure, which resulted in a bank run. After having tried in vain to coordinate a private rescue, the British government reluctantly nationalized Northern Rock. In the USA, meanwhile, the Federal Reserve cut interest rates aggressively in an attempt to prevent large-

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<sup>2</sup> See e.g. the contributions to a recent symposium in *Political Studies Review* (Vol. 8 [2010], No. 1).

<sup>3</sup> For comprehensive accounts of the crisis see for example Cable 2009, Gamble 2009, Peston 2008.

scale financial defaults. Nonetheless, during 2008 numerous bank failures and rescues took place, beginning with the collapse of the investment bank Bear Stearns in April 2008 and followed by government bailouts of mortgage lenders Fannie Mae and Freddie Mac.

By the summer of 2008 it had become clear that the financial crisis was not confined to sub-prime mortgages but in fact permeated the whole financial system. This has been a direct result of the way in which debts had been transformed into a complex array of diverse securities and sold on to other financial institutions. As in other financial bubbles before, leveraging had become widespread and a complex web of legal Ponzi schemes had been created. At some point, uncertainty among bankers about the real value of the assets on their books took over. A gigantic paper mountain of debt had been erected on tiny capital bases and expectations of infinite growth in financial markets. Once these foundations were called into question, the entire edifice crumbled. The collapse of Lehman Brothers, one of the world's leading investment banks, in September 2008 marked only the peak of the iceberg. The US financial authorities decided not to bail it out with government funds and allowed it to fail, setting off a wave of panic selling which for a short while threatened the stability of the entire financial system. Without the swift intervention of governments that stepped in to underwrite and even nationalize many institutions, this could have led to the collapse of some of the leading banks in Britain and the United States.

In autumn 2008 the crisis began spread to the 'real economy' via reduced liquidity, sector price inflations (mainly in food and energy) and the general slowdown of the US economy. The economies of France, Germany and the UK and a host of other developed countries contracted. Economies with large financial exposure, such as Iceland or Ireland, felt the full force of the financial crisis and entered recession quickly. Initial hesitance by Republican to bailout plans in Congress precipitated a further dramatic collapse of the stock market. To stem the decline the British and US governments announced the use of 'quantitative easing', including setting interest rates to under 1 percent to increase the money supply and counteract deflation. The rises in liquidity, asset relief funds, nationalizations, and other quasi-Keynesian responses are hoped to spark an early recovery but put unprecedented strains on public finances – in the UK more than in other developed capitalist countries.

*The political decisions leading to the crisis*

Throughout the 1990s, and more so following the 1997 Asian financial crisis, many analysts had warned of the dangers of what was happening in the financial markets (Krugman 2000, Stiglitz 2002, Strange 1998). Almost everyone agrees now that there was over borrowing and under-saving both in the public and private sectors, and that the markets ran ahead much too far and too fast (Peston 2008; Soros, 2008; Gamble 2009). Bankers and traders were ingenious at creating new financial instruments – most famously the ‘collateralized debt obligation’ – that allowed the inextricable pooling of ‘prime’ and ‘sub-prime’ mortgages. While lending expanded and the asset price bubbles continued inflating, an expansive non-bank financial system (or ‘shadow banking system’) was effectively in operation, channelling vast amounts of largely fictional assets.<sup>4</sup> Many people in the financial markets, including Alan Greenspan, believed that the financial markets had become so sophisticated that they were able to price any risk, and adjust to any shock (Krugman 2008, 139-52). The complexity of the system and the fact that no one mind could grasp it or understand what was going on was seen as positive as it meant that the order created by the markets was spontaneous and unplanned and all the more robust because of it (Gamble 2009).

What were the political factors that facilitated the boom and thereby created the conditions of the crash? Here, opinions diverge more substantially as to whether the problem was caused by too little regulation or by ineffective regulation, and therefore whether regulators or bankers should be most blamed for the mess. In addition, mistakes made by individual regulators who did not spot the danger to the financial system until it was too late have been highlighted (Gamble 2009).

New regulatory systems for finance, both national and international, were installed from the 1980s onwards, and which involved the scrapping of many of the safeguards designed to prevent another financial crisis, such as the Glass-Steagall Act dating back to the 1930s. This Act, which had prohibited a bank holding company from owning non-bank financial institutions and thereby lent force to minimum base capital requirements for banks, was repealed in 1999. Under the new rules different jurisdictions competed with one another to offer the least intrusive regulation on financial institutions in order to attract subsidiaries of the big international banks. Light-touch regulation was embraced, albeit to different extent, by policymakers in all countries and of all mainstream partisan affinity. In the UK, for

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<sup>4</sup> In early 2007, the combined assets of the five major US investment banks accounted for \$4 trillion – or roughly 40 percent of the total assets of the entire US banking system (Krugman 2008, 161)

example, in the years before the crash the Labour government was regularly criticised by the Opposition when it proposed any measure that might damage the competitiveness of the City of London (Gamble 2009). Internationally, the replacement of the Bretton Woods system with a global financial system of floating currencies facilitated international trading in securitized debt.

There are other important factors that contributed to the crisis, such as international structural developments like China's role in the world economy as a producer and capital exporter. But the light touch regulatory regimes governing financial markets throughout the 'first world' were a major encouragement for bankers and consumers alike to take bad risks and join Ponzi schemes of unprecedented scale. Thus, it can be assumed that political decisions to relax regulation of financial markets relative to their increasing complexity created the institutional environment in which an asset bubble could grow to enormous proportions – and burst. In the Irish case, this had been exacerbated by government policies such as tax breaks for property investment and development and insufficient regulation of bank lending criteria.

## **Explaining political decision-making**

### *1. Lobbying*

If financial interests want to lobby policymakers with the aim of obtaining desired regulation or preferential taxation, they have to gain access to these political decision makers. Interest groups cannot be successful in their endeavours if they lack access to one or more of the key points of decision-making in the government (Truman 1963: 264–70; Schlozman and Tierney 1986: 104). Economic elites find it generally easier to gain access to politicians than other groups. For example, guests at a fundraising dinner with the governor of California, Arnold Schwarzenegger, in February 2004 were expected to donate anything between \$50,000 and \$500,000 for a seat at the meal (The Guardian, 21 February 2004). While at the time this dinner was billed as the biggest fundraiser in the history of politics, similar events in the US regularly command expected donations of five and six digit sums. Clearly, few people are in a position to attend this kind of event who are not also members of an economically advantaged group – a characteristic that, in Western capitalist countries, is strongly correlated with ownership of, and leadership positions in, business enterprises, including financial institutions.

Yet, not all political parties, candidates, and policymakers manage their accessibility in this way. Left-leaning politicians have traditionally had open ears for non-business interests, such as trade union representatives or, indeed, ordinary citizens. Research undertaken by Chin, Bond and Geva (2000) on lobbying in Washington DC suggests that politicians of any partisan affiliation value ordinary constituents' interests no less than business and money givers. According to one of the Washington staffers they interviewed, '[i]nterest groups may use PAC status to get a foot in the door, but constituents generally find that door open when they call' (quoted in Chin, Bond and Geva 2000: 545). In European countries, where local constituency interests are generally less central to the work of national parliamentarians than in the US or the British Isles, comparisons between producer and non-producer groups may be more apposite than the opposition between constituents and non-constituents.

Enjoying preferential access to policymakers is one thing, but translating these opportunities into political influence may be quite another. While conceding that business has superior political resources such as money, organization and status, pluralists have long argued that the existence of these resources does not imply that they are effectively employed or actually make a difference for political outcomes (Wilson 1981: 37). Elected politicians may talk to just about everybody in their constituency and listen to their concerns, but that does not tell us much about how they weigh the information they receive. Determining the influence of lobbyists is complicated by the difficulties of identifying when influence has occurred and when there is really only parallelism of purpose and action between the lobbyist and government official (Salisbury 1975: 207). It may not be surprising, then, that empirical studies of the effects of interest group activities on political outcomes have produced inconsistent and non-robust findings. In particular, researchers have found it difficult to explain legislative and regulatory outcomes by reference to overt political pressure from organized interests, or to the differential resource endowments of groups as measured by their membership, strategic position, organizational strength, or simply the amount of money injected into a lobbying campaign (Baumgartner and Leech 1998: 106–108; Smith 2000: 115–41). The enormous research output generated in relation to the political effects of corporate campaign contributions is a good example of the general failure in pluralist research to connect political inputs (e.g., money) to outcomes (i.e., policy). Material contributions to candidates or legislators generally neither account for election results nor for the policymaking behaviour of the recipients (Roscoe and Jenkins 2005). Given that in most countries such contributions are legally restricted to a few thousand US Dollars at a time,

while larger sums that may change hands illegally are notoriously difficult to trace, this is perhaps not very surprising. Very few authors deviate from this diagnosis (but cf. Sabato 1984). As a result, pluralist theories of interest group politics have in general proved unsatisfactory for explaining policy outcomes.

From a theoretical vantage, Morton and Cameron (1992) highlight the importance of policymakers' ideological and electoral incentives. They suggest that one of the reasons for the many weak and contradictory findings in studies on the policy effects of interest group activity is the implicit, unrealistic assumption that voters condone sell-outs by incumbent politicians to organized interests. This qualification applies a fortiori to big business and financial interests. The objection echoes Truman's earlier claim that the efficacy of pressure politics by sectional interest groups is ultimately circumscribed and constrained by largely unorganized interests that are so widely held in society that they are 'taken for granted' (Truman 1963: 512). Thus, in the event that powerful organized interests manage to capture the policymaking process, the otherwise unorganized interests would mobilize in order to claim conformity with the democratic rules of the game. Because of their desire for re-election, political representatives will be responsive to these demands, being thus constantly held accountable by Truman's 'taken for granted' interests. In the pluralist tradition, this mechanism provides the ultimate check against the domination of public policy by organized sectional interests, including business.

The problem with this view is that the latent interests of the silent majority may fail to become actual and vocal even if they are being exploited by special interests. Mancur Olson (1965) has identified the free rider problem of collective action as an important source of the policy bias toward special interests. Because large groups face relatively high costs when attempting to organize for collective action while small groups will have relatively low costs, the former are at a disadvantage even if they form the numerical majorities that are expected to prevail in democratic politics. In addition, the members in large groups will gain less per capita of successful collective action compared to members of in small groups, so that large groups are less able to act in their common interest than small ones. In Olson's words, '[t]he smaller groups – the privileged and intermediate groups – can often defeat the large groups – the latent groups – which are normally supposed to prevail in a democracy (Olson 1965: 127–8). Salisbury (1984) also finds that business has a systematic advantage over others in politics

because business corporations and trade associations are ‘institutional groups’, who tend to be able to sustain a more permanent presence in the policymaking process.

Not only is a small group of firms in an oligopolistic industry in a better position to overcome free-rider problems, but in many cases the entire collective action problem of obtaining public goods does not apply in the first place. This is because much political activity of firms is directed at obtaining ‘private goods’ (Godwin and Seldon 2002). Rather than collectively opposing a policy wholesale, individual businesses engage in ‘loophole lobbying’, concentrating on very specific aspects of the policy with the aim of minimizing the cost implications for themselves (Polk and Schmutzler 2005). Godwin and Seldon (2002: 216) report, for example, that airline lobbyists in Washington DC spend ‘75–95 per cent of their time on issues affecting only their firm or their firm and one other.’ The heavy lobbying by Citicorp to have the remaining provisions of the Glass-Steagall Act removed can be seen as an instance of such private goods seeking. Although the 1999 Gramm-Leach-Bliley Act eventually allowed every major player in the industry to form financial services conglomerates offering a mix of commercial banking, investment banking, insurance underwriting and brokerage, Citigroup’s acquisitions of Travelers Group in 1998 and Associates First Capital Corporation in 1989 made the legislative change particularly useful for this bank.

The idea of small, efficient groups hijacking the policy process at the expense of latent groups relies on some degree of voter ignorance. Political incumbents have to be able to systematically fool a majority of voters by favouring special interests while keeping the costs imposed on the majority below some awareness threshold (Becker 1983: 391–4). In the case of financial market regulation, this is not difficult to achieve. Firstly, the potential costs from risky financial strategies and the necessary permissive regulation are widely dispersed across large numbers of potential victims. Secondly, any costs are likely to be incurred at an unknown point of time in the future. And secondly, there may not be any costs, at least as perceived by all the relevant actors, as the possibility of something going wrong is just that – a possibility, but not a certainty. In addition, because information gathering is costly, voter rationality implies incentives for the electorate to be ill informed (Downs 1957).

Information asymmetry is crucial in all aspects of lobbying: Had policymakers had better understanding of what was going on – independently of the information they were given by

lobbyists – they may have decided differently when debating deregulatory moves such as the Gramm-Leach-Bliley Act.

## *2. Elite integration*

A coherent and tightly organized business community might of its own not pose very serious problems for democracy – as long as economic elites can be assumed to constitute groups and encompassing individuals that are largely distinct from public decision making bodies and their members. However, cases like Silvio Berlusconi, the former Irish deputy prime minister Mary Harney, or appointments of business leaders ministerial posts as with the former director-general of the Confederation of British Industry (CBI), Digby Jones remind us that personal and family unions between political and business empires are a regular occurrence in Western democracies. In addition, the captains of industry and finance share many social and sometimes professional, educational, and recreational experiences with politicians and leading civil servants. This has been the stuff of social science inquiry since the elite theories of Hunter (1953) and Mills (1956). Cookson and Persell (1984) document the historical role performed by elite preparatory schools in the formation and maintenance of the American upper class. Historically, the collective identity forged in these prep schools would become the basis of upper-class solidarity and consciousness – a process of elite integration that is continued in the Ivy League universities. In the UK, similar functions are performed by ‘public’ schools and the Oxbridge colleges, while in France the Ecole Nationale d’Administration is the unique cadre production facility that no aspiring politician, civil servant or manager can afford to bypass (Miliband 1969: 55–67).

Using data from interviews with over 500 leaders of major political, economic and social institutions, Moore (1979) has demonstrated the existence of largely unfragmented elites in different institutional and issue-related contexts. The structure of the networks indicates that at least a strong potential for unity among elites exists, and that almost all of the individuals involved have a high potential for political influence due to their incumbency in high-level positions. Thus, the structure exists through which elites in various institutions can become unified in the pursuit of common goals. Crucially, however, Moore finds that these networks are formed around specific issues, and that membership in a network is not so much the result of privilege from birth or upbringing, but derives from the issue-related interests shared by the members of the network. This result corresponds to the earlier political science literature on policy communities, which argued that economic elites proceed by developing

relationships and entering into alliances with the relevant branches of government such as ministerial civil servants and parliamentary committees, creating what became known as ‘islands of functional power’, ‘policy subsystems’, or ‘iron triangles’ (Maass 1951; Redford 1969; Sayre and Kaufman 1965).

These functional, rather than social, ties between the members of economic and political elites are reinforced by the politics of the ‘revolving door’ (Salisbury *et al.* 1989). Firms find it attractive to hire former senior civil servants, regulators, and even cabinet ministers for their technical expertise and social connections. Once in their new private sector positions, the former policymakers use their connections and influence to further their new employers’ political interests as well as using their factual expertise to advise them on government relations and regulatory matters. Similar passage in the opposite direction also occurs. A prominent example of someone who has travelled the revolving door full-circle is the current US vice president Richard Cheney. In the UK, there is an established revolving door between the Foreign Office and petroleum firms such as Shell: four of the last five permanent heads of the Foreign Office have moved on to become directors of oil and gas companies; two of them at Shell (*The Guardian*, 15 May 2007).

According to Hecló, the functionally more important phenomenon are so-called ‘issue networks, i.e., shifting coalitions involving policymakers, interest groups, and professional lobbyists. In a similar vein, the ‘policy advocacy coalition’ approach of Sabatier and Jenkins-Smith (1993) analyses how different interest groups temporarily join forces to advance their common interests.

By contrast, Richardson and Jordan’s (1979) analysis of elite integration in British ‘policy communities’ encompassing civil servants and business actors suggests something more permanent than the relatively ephemeral issue networks. These policy communities are seen as clusters of special interests and policymakers within a given policy area that tend to be quite institutionalized and effectively exclude other groups from the policy process. In a similar vein, ‘policy network analysis’ views the political involvement of business primarily as the developing and maintaining of close relationships with policymakers and other actors with common stakes in a policy area (Marsh and Rhodes 1992). Common to all sectors is the notion that ‘[t]he existence of a policy network, or more particularly a policy community, constrains the policy agenda and shapes the policy outcomes’ (Rhodes and Marsh 1992: 197).

Policy change takes place if and when the relevant policy community agreed it was necessary and a consensus exists on the direction of change (Richardson 2000: 1006; Laumann and Knoke 1987; Heinz *et al.* 1993; Knoke *et al.* 1996).

More recent research on policy network formation suggests that the same factors that endow actors with influence over a particular area of public policy also account for why these actors are included in the relevant issue network or policy community (König and Bräuninger 1998). Similarly, Maloney, Jordan and McLaughlin (1994) emphasize the exchange-based nature of the relationship between interest groups and policymakers. ‘Insider groups’ have preferential access to policymakers because of their perceived legitimacy from claiming to speak for a segment of the population. Policymakers offer organized interests the opportunity to shape policy while groups provide policymakers with useful resources including knowledge, advice and expertise, membership compliance, and implementation guarantees (Maloney, Jordan and McLaughlin 1994: 20–7). Thus, it is what groups bring to the consultation process that determines the extent to which they acquire influential status in a policy community or network.

Tony Blair’s move from heading successive UK governments that embodied the light touch approach to financial market regulation more than the governments of any other large European country to joining JP Morgan – one the prime beneficiary of such deregulation – as an advisor is perhaps the most high profile example of the role revolving door politics played in the making of the financial crisis. Top bankers personally run the agencies charged with regulating them, illustrating how financial market regulation has been marked by extreme levels of agency capture. The current Chief Executive Officer of the Financial Services Authority, Hector Sants is a former Head of European Equities at Warburg Dillon Read and former First Vice President of UBS Securities.

The chairman of the agency, Adair Turner, is a former director of McKinsey & Co, the management consulting firm that specializes, among other things, finance and investment. A former Director-General of the Confederation of British Industry (CBI), Turner also worked as Vice-Chairman of Merrill Lynch Europe. His predecessor, Callum McCarthy, who headed the agency throughout the run-up to the financial crisis, had previously been Director of Corporate Finance at investment bank Kleinwort Benson, as well as Managing Director and

Deputy Head of Corporate Finance of Barclays' investment banking arm, BZW, and subsequently, CEO of Barclays Bank group operations in Japan and North America.

In the USA, the former Treasury Secretary Hank Paulson is also a former chairman of Goldman Sachs. This list could be continued for some length, but these few, high profile examples should suffice to illustrate the extent to which the staffing of financial regulatory agencies has meant putting foxes in charge of the hen house.

### *3. Elite ideology*

When bankers become regulators or when politicians become bankers, they do not just safeguard the interests of the institutions that paid them handsome incomes in the past (Turner) or future (Blair), they also participate in the cultivation of common understandings and knowledge about how the financial world works and what policies are best suited to the smooth running of the financial system. These ideas are generated, refined and reinforced by 'epistemic communities' (Haas 1992), comprising of financial service institutions (banks) and regulators. In the words of Haas (1992, 27), 'epistemic communities are channels through which new ideas circulate from societies to governments as well as from country to country.' They influence state interest by elucidating the cause and effect relationships; shedding light on the nature of the complex inter-linkages between issues and on the chain of events that might proceed either from failure to take action or from instituting a particular policy; or by helping to define the interests of a state or factions within it. More practically, epistemic communities help to formulate policies through framing of alternatives and implications of possible actions. Formally, an 'epistemic community' is a network of knowledge-based experts or groups with an authoritative claim to policy-relevant knowledge within the domain of their expertise. Members hold a common set of causal beliefs and share notions of validity based on internally defined criteria for evaluation, common policy projects, and shared normative commitments.

The epistemic community of financial regulation cultivated a perspective on financial markets and their regulation that prohibited its members from spotting the danger to the financial system until it was too late. This is the neo-liberal ideology of unfettered markets and deregulation that has dominated political discourse and action in western democracies since the 1970s. It has led policymakers around the world to rely unduly on the ability of markets to correct themselves, perhaps with the aid of occasional monetary adjustments by

central banks. Even the left-of-centre governments that were in charge of the majority of West-European and North American countries throughout much of the 1990s were ideologically committed to these views and steered their economies toward the – then distant – abyss. The strong hegemonic hold can be seen in the biased meaning of terms like ‘prudence’ (equated with small government debt and the implication to desist Keynesian countercyclical measures) or the unequivocally positive connotation of ‘light touch regulation’. The set of beliefs shared by these epistemic communities justified promoting the financialization of citizens, encouraging households to rely on credit to paying for immediate consumption, housing, and provision for old age (Crouch, 2008).

These communities are not perfect. Dissenting views and voices exist, but they are not usually rewarded kindly for upsetting the consensus shared by the majority. An example of this is Paul Moore, the former Head of Group Regulatory Risk at HBOS. Moore shared his concerns about the banks’ risky behaviour with both the bank’s board and the FSA, but did not find an interested audience. Instead, he had his employment terminated by HBOS’s then chief executive, James Crosby, after Moore told him that the board’s actions could ‘lead to disaster’ (*Daily Telegraph*, 11 February 2009). Crosby, a close adviser of Gordon Brown, was subsequently appointed deputy chairman of the FSA by the Treasury. The epistemic community remained intact. In September 2008, HBOS's share price suffered wild fluctuations related to the bank’s exposure to the wider credit crunch. A takeover by Lloyds TSB was negotiated and facilitated by the government, who sanctioned a bypassing of competition law, anxious to avoid a repeat of the Northern Rock collapse.

#### *4. Mass ideology*

Economic ideas are powerful political tools that can be used by actors to shape policy. This, it is sometimes argued, is most effectively done by defining how the economy works, what is wrong with it, and what would improve it (Blyth 2002). Blyth has argued this for the profound changes in the economic order in major capitalist countries in the 1930s and 1970s. He argues that the 1930s the masses reacted against the exigencies of the market and demanded state action to mitigate the market’s effects by ‘embedding liberalism’ and the 1970s, those who benefited least from such ‘embedding’ institutions, namely business, reacted against these constraints and sought to overturn that institutional order. Blyth argues that economic ideas played a critical role in making these institutional changes possible.

The theoretical approaches surveyed so far all assume a distinction, as well as a certain discrepancy, between the preferences of a majority of citizens and those of the financial and political elites. However, a striking observation about the developments that led to the financial crisis is that economic elites and the masses of citizens largely agree on how the economic and housing needs of private households are best served. Firstly, the commodity fetishism that underlies the belief that annual increases in house prices of 20 percent or more reflect increases in the value of these houses was a near-universal attitude – and one that seemed to have been confirmed over a decade by experience. And secondly, citizens throughout the western world have lent strong electoral support for political parties campaigning on ‘pro-market’, neo-liberal programmes.

But how do economic elites manage to utilize economic ideas for their political ends? One way would be to spread these ideas throughout society in order to ensure popular acquiescence, if not approval, with one’s political agenda. The mass media are often said to be easily accessible to the business message (Miliband 1969: 227–38). Mitchell demonstrates that the mass media are also generally very sympathetic to business, as judged by the perceptions of business representatives and trade unionists (Mitchell 1997: 50–1). This finding is supported by content analysis of media coverage of economics and politics (Glasgow University Media Group 1980). And Page, Shapiro and Dempsey (1987) have shown that it is possible to influence public policy preferences if the position of those doing the influencing is backed up by expert opinion or framed as being in the public interest. The required expertise and scholarly underpinning of business-friendly messages, it is argued, is regularly provided by conservative think tanks such as the Heritage Foundation and the American Enterprise Institute in the US, or the Centre for Policy Studies and the Adam Smith Institute in the UK (Smith 2000: 189–96). Thus, the prerequisites are there for business to be able to manipulate citizens’ preferences and public opinion in such a way that business interests will seldom be vitally challenged in politics. Business, in this sense, is powerful to the extent that it can exercise hegemonic dominance to prevent people from conceptualizing challenges to its interests (Wilson 2006: 35).

The implied dominance of elite interests in the formation of public opinion was famously theorized by Lukes’ (2005). He argues that, instead of conflicts of preferences, the social and political world is formostly characterized by latent conflicts of real interests. What prevents a latent conflict from erupting into an open clash of wills is the fact that people whose

preferences diverge from their interests are unable to realize this. Third-dimensional power, for Lukes, thus consists in the ability of some agents to intentionally manipulate other people's beliefs and preferences: 'A may exercise power over B ... by influencing, shaping or determining his very wants' (Lukes 2005: 27). Effectively, this is the ability to distort people's beliefs through indoctrination and propaganda to prevent conflict from arising in the first place – considered by Lukes to be 'the most effective and insidious use of power' (Lukes 2005: 27). The resulting beliefs, preferences, and wants that contradict a person's or group's 'real interests' can best be described with the Marxist term of 'false consciousness' (Hyland 1995: 201).

This line of reasoning assumes a distinction between a people's subjective preferences and their objective interests. But the necessity of giving a coherent account of a person's objective interests independent from subjective preferences inevitably has to employ a normative theory of human nature, which will not be open to straightforward proof and disproof (Hyland 1995: 203). Lukes is aware of this problem and admits that different conceptions of interests are based on different moral and political positions (Lukes 2005: 37). Far from solving the problem of objective interests, however, this merely illustrates the 'epistemological relativism' of the concept of third-dimensional power (Hyland 1995: 203). A further problem with the notion of ideological manipulation is the fact that any defensible theory of human nature will inevitably be based on human experience (Hyland 1995: 203). According to the concept of third-dimensional power, however, human experience is itself distorted, since it is exposed to the working of third-dimensional power in the form of 'the control of information, through the mass media and through the process of socialization' (Lukes 2005: 27). According to Hyland, this leads to circularity of the argument: 'If we base our theory of human nature on distorted experience we will be unable to detect third-dimensional power; but we will only be able to determine which experiences and forms of consciousness are the products of distortion after we have formulated a defensible theory of human nature' (Hyland 1995: 203).

The problem is not so much the notion that individuals or groups hold beliefs that prevent them from appropriately interpreting their situation of subordination and subsequently taking steps to transform their grievances into political issues. Furthermore, such misguided beliefs may even be shown to serve the interests of some dominant group of people. The problem consists rather in the notion of the intentional manufacturing of these beliefs by the wielders

of third-dimensional power. According to Elster, preferences tend to be co-determined by the feasible set of options. Elster calls this adaptive preference formation, which he defines as ‘the adjustment of wants to possibilities, ... a causal process taking place ‘behind the back’ of the individual concerned’ (Elster 1982: 126–7). Rather than being the product of some external manufacturing, however, adjusted preferences are developed endogenously. The fact that adjusted preferences on part of the subjects are beneficial to the interests of other agents does not by itself warrant the conclusion that the latter play an active role in the formation of these beliefs.

This is not to say that elites are entirely inactive with respect to beliefs and desires created in others. Indeed, ideological indoctrination has always been part of what can be perceived as political culture in a broader sense, and most likely always will be. However, such instances of indoctrination are as much the ideology of the rulers as they shape the beliefs of the masses (Elster 1983: 116). To the extent that indoctrination takes place, it can be successful only because the rulers – and, of course, the actual preachers – themselves believe in it (Elster 1983: 117). Attempts of purposively producing mental states in other persons are bound to fail, unless there is little doubt on part of the recipient that the propagated beliefs are genuinely shared by the sender (Elster 1983: 66–71).

This makes sense when applied to mass beliefs about the benefits of free enterprise, the rewards of leadership and success in financial institutions, as reflected in bonuses and salaries. Bankers and traders by and large genuinely believe that their activities are key to national wealth creation and that the universal financialization of citizens through private home ownership and debt that has taken root in the UK and USA is beneficial not only for them but also for the consumers and home-owners.

##### *5. Structural dependence of the state on (financial) capital*

Economic performance is of overarching importance for the popularity and electoral success of politicians. Since Key’s (1968) study, *The Responsible Electorate*, popularity functions assume a reward–punishment model of political popularity and electoral success: If economic conditions are good the electorate will reward incumbents, while it will punish them if the economy is less than satisfactory (Alvarez, Nagler and Willette 2000; Lewis-Beck and Stegmaier 2000; Duch and Stevenson 2006). Policymakers anticipate the effects of economic voting in their policy decisions and strategic behaviour (Kiewiet 2000; Palmer and Whitten

2000). As a special case of Friedrich's (1963) 'law of anticipated reactions', economic voting is the mechanism through which the structural power of business unfolds. This is the classic theory of business' structural dominance. In the words of Przeworski and Wallerstein, '[t]he effective capacity of any government to attain whatever are its goals is circumscribed by the public power of capital. ... It does not matter who the state managers are, what they want, and whom they represent. ... Capitalists do not even have to organize and act collectively: it suffices that they blindly pursue narrow, private self-interest to sharply restrict the options of all governments' (Przeworski and Wallerstein 1988: 12). Far from being an exclusive claim of structural Marxist theories of the state in capitalist society, this notion is also a central tenet of neoclassical political economy (e.g. Becker 1983). The social and political implications are considerable. If the theory is true, democratic politics is a mere sham.

Because their political survival depends on a healthy economy guaranteeing adequate state revenues and political legitimacy and support, and major investment decisions in a capitalist system are usually private, public officials cannot risk a capital strike by proposing policies that threaten the owners of capital (Lindblom 1977: 170–88). But although the constraints on non-distributive policies that result from the interaction of centralized authoritative decision making by policymakers with the decentralized, allocative decisions of private market actors are often overlooked, structural dependence theory actually predicts constraints on all policies that could adversely affect business' revenue prospects,. For example, Sunstein has highlighted how the aggregate outcomes of the decentralized responses to deliberative decision making can have unintended consequences that render measures of public policy inefficient, reverse their intended effects, or even avert their very formulation in the first place should the policymaker anticipate such adverse reactions. Elaborating this problem in the context of risk regulation, Sunstein (1998: 235–6) distinguishes between risks that the government is trying to control by means of regulation ('regulated risks') and the risks that are increased by the same regulation by way of unintended side-effects ('ancillary risks'). A quarter century earlier, Peltzman (1973) showed how safety and efficacy regulation on drugs can backfire by thwarting innovation and research on new and improved drugs.

Examples of this pervasive problem are not uncommon in the context of financial market regulation. Bernhagen and Bräuninger have traced how the four largest retail banks in England and Wales (Barclays Bank plc, HSBC Bank plc, Lloyds TSB Bank plc, and National Westminster Bank) fought government regulation aimed at encouraging greater competition

in small business banking. The banks argued that the regulation might end up harming rather than helping SMEs. According to the British Bankers' Association, the measures could undermine the potential competitors' attempts to break into the market, as part of their unique selling point was paying interest on SME current accounts. The banks further pointed out that price controls might result in the banks trying to recoup some of the costs by increasing charges elsewhere, for example by raising the price of loans to SMEs (Bernhagen and Bräuninger 2005).

According to Gamble (2010), the reason why so many countries were prepared to abandon or forgo tighter regulation of financial market activities was that the growth of the financial services sector was a key engine of the growth that was experienced in the 1990s. This financial growth model extended a lot further than just seeking to attract foreign banks.

The structural explanation of business political privilege is a powerful theoretical argument, but it has a number of problems. Firstly, if the structural power thesis holds, we should rarely witness policy change over time that overrides business complaints regarding the detrimental effects of a policy. However, instances of business failing in the policy struggle are frequently observed. They are more likely when external events such as scandals or catastrophes create an environment that is conducive for policymakers to embark on a 'fit' of heroic policymaking (Mitchell 1997: 10). In these situations, policymakers are able to temporarily override the business confidence factor and the negative inducement effects commonly attributed to such disregard. In this view, the structural grip of business on public affairs varies as a function of irregular, shock-like perturbations to the political climate within which business operates.

The theory's implication that the partisan composition of governments does not matter for political outcomes does not fare well in the light of empirical evidence. While some authors detect a process of convergence of party platforms (Caul and Gray 2000), others (e.g. Quinn and Shapiro 1991) find that partisan change in the US has noticeable effects on the country's tax policies. And in a cross-national comparative study, Garrett (1998) finds that the partisan composition of government continues to affect levels of government spending even under conditions of considerable integration into global markets. He also notes that left-leaning governments always outspend rightwing governments. Furthermore, and contrary to much lore about the political effects of globalization, Garrett finds that the spending lead of left-

leaning governments increases with global economic integration (Garrett 1998: 74–105). Finally, the notion that parties matter has, at least until recently, been shared by business representatives themselves. Whether warranted by political realities or not, business leaders overwhelmingly believe that Social Democratic or Labour governments are bad for business, while right-leaning and business-friendly parties are expected to do a better job in that regard (Grant 1993: 137–8). However, the dependence of governments on revenues from capitalist activities is perhaps nowhere better illustrated than in the context of successive New Labour governments in the UK throughout the late 1990 and first decade of the new millennium. The labour government's 'tax and spend' policies (e.g. on health and education) were financed to no small part by tax and foreign currency earnings from a thriving City.

#### *6. Institutions: Varieties of Capitalism*

The landmark events and processes that have characterized the findings, as well as the frequently mentioned political decisions facilitating these processes have mostly occurred in the US and the UK. Partly, this has to do with the sheer size of the US economy and the importance of the City of London as a financial market place. But it also highlights important institutional differences between the liberal market democracies of the Anglo-Saxon world and the more coordinated, or 'embedded' capitalist orders found in many European and Scandinavian countries (Hall and Soskice 2001). Banks throughout the developed world have incurred major losses, but the activities of UK banks that resulted in these losses appear to conform more to the features of the Anglo-Saxon version of financial capitalism and the banking operations associated with this. By contrast, in France and Germany, banks' activities traditionally tended to be domestically, even regionally, oriented (Hardie and Howarth 2010). However, authors have noted a convergence in the German and French financial systems over the past decade towards the British system, potentially undermining distinctive national varieties of financial capitalism. This convergence concerns primarily the 'financialization' of bank operations, with regard to both assets and liabilities. Nonetheless, British bank financialization – especially on the liabilities side – continues to exceed the levels found in Germany and France.

#### **Discussion: lessons for politics and lessons for political science?**

Do the six explanatory strands outlined above help us understand how the world got into the mess it is presently in? Is any one of these theories better suited than the others for explaining the regulatory inadequacies, or does it require more than one to make sense of what happened

and help in preventing a repeat of the drama in the future? Re-regulating the financial markets in the wake of the crisis may not be easy to accomplish. But a sound understanding of the developments that brought us here is needed if any lessons are to be learned from recent and current experience. Political science has the potential to aid in this explanatory endeavour. The present paper has sought to start the process by discussing the political decisions and non-decisions that were ‘needed’ for the crisis to unfold the way it did in the light of standard political science theories.

As Gamble (2010, 7) points out, ‘[t]he argument that better regulation might have avoided or moderated the crisis has some force since there was nothing inevitable about the rush to deregulate.’ Some countries (e.g. Canada and India) regulated their financial sectors more carefully than others (e.g., Ireland, UK and USA). While that does not shelter them from the fallout of a global economic crisis, the financial sectors of these economies were less affected by the financial crisis. This relationship has to be tested more systematically if policy implications are sought from political scientists.

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