Introduction

The sudden onset of the global financial crisis triggered a whole series of shock waves that rippled through the global economy, causing major social and political dislocations along the way. As the media began fielding sweeping accusations of inherent corporate greed, as the root of the evil, financial district streets in New York and elsewhere filled with violent protesters demanding retribution. In consequence, corporate jets were grounded and corporate executives could be seen using high-occupancy vehicle (HOV) lanes when traveling to the U.S. Congress with pleas for taxpayer bailouts. At the height of the storm, financial market operators even elected to dress down in public, for fear of personal reprisals.

Driven by justifiable wrath from the side of those who lost not only jobs but in many cases also homes and life savings, politicians responded with shows of great resolve in hunting down the culprits. A prominent but far from isolated example was the Republican senator John McCain, who used a September 2008 presidential campaign rally to vow that if elected he would "put an end to the reckless conduct, corruption, and unbridled greed that have caused a crisis on Wall Street."[1] Sensing how the winds were blowing, others followed suit.

As such, there was nothing really strange in any of this. The collapse of major multinational corporations, some of which had been widely admired for their prowess, was followed by revelations of lavish bonus schemes and of self-serving corporate behavior that seemed to defeat even the wildest of fantasies. Culminating in the scandals surrounding Bernard Madoff, the perpetrator of the most massive Ponzi scheme ever, public anger broadened to include failures of financial oversight, exacerbated by accounts of

[1] See further http://www.motherjones.com/mojo/2008/09/mccain-attacks-wall-street-greed-while-83-wall-street-lobbyists-work-his-campaign (accessed on May 12, 2009).

whistleblowers allegedly having been ignored. The general atmosphere of *furore* against financial market sharps brought back literary memories of how Dante once placed those guilty of greed in the fourth circle of Hell.

Beyond the immediate outpouring of anger and emotional calls for retribution, the global financial crisis also resulted in more fundamental discussions about the nature of capitalism and of the modern market economic system. Erupting in the wake of the failure of neo-liberal economic reforms in Russia, it provided new momentum to long-standing criticism of neo-liberal economic policies more generally. Given the combined seriousness of the global recession of 2008–9, and of the preceding hyperdepression that ravaged Russia in the 1990s, it is rather understandable that familiar old debates about the eventual fate of capitalism would re-emerge, with some even expressing glee at its pending demise. We shall have more to say about this later.

Less politicized settings were marked by more balanced reflection on matters such as the increasing attraction of Keynesianism over monetarism. Anticipating the dawn of a new era of greater government intervention in the market, some expressed worries that such intervention would overshoot, resulting in impediments to growth. More broadly, arguments were also made on the superior virtues of, say, German "social market economy" over the alleged greed of Wall Street.

We shall have no ambition here to follow in any of these tracks. Aiming to penetrate beyond such largely political and ideological debates that concern a poorly defined "crisis of capitalism," we shall prefer instead to probe for causes of systemic failure that are inherent, and firmly rooted, in the set of institutional arrangements that constitutes what we know as market economy. The scope of the investigation will in consequence be much broader than simply financial markets.

Speculating on the role of capitalism beyond the subprime mortgage crisis, Amartya Sen notes, "The question that arises most forcefully now concerns the nature of capitalism and whether it needs to be changed." Arguing that the "idea of capitalism did in fact have an important role historically," but that "by now that usefulness may well be fairly exhausted," he points to a need to discuss what "kind of economics … is needed today."[2]

Our approach in this text will depart from the latter part of this statement. More specifically, it will investigate how economics has grappled with the inherent contradiction between self-interested behavior that is value

[2] Sen, Amartya (2009), "Capitalism beyond the Crisis," *New York Review of Books*, vol. 56, no. 5, p. 1 (cited from www.nybooks.com/articles/22490, accessed on May 14, 2009).

adding, and that tallies well with the ideal of Smithian laissez-faire, and the opposite case of behavior that degenerates into pure greed, with broad – and presently all too obvious – repercussions for the stability and functioning of the market economic system.

It will be argued, rather boldly, that the global financial crisis combined with the previous experience of failed systemic transformation in post-Soviet Russia – and indeed with several decades of failed ambitions to promote development in the Third World – to bring home the need for a new departure in social science as a whole. As evidenced by the rather dismal outcomes, the theoretical and practical tools that have been available to deal with problems inherent in these processes have simply not been up to the task. Above all, this has been true with regard to the role of cultural and historical specificity in determining how actors will respond to changes in opportunity sets.

The core of the theoretical challenge that emerges here may be captured in Lionel Robbins's statement that "the pursuit of self-interest, unrestrained by suitable institutions, carries no guarantee of anything but chaos."[3] Culled from his *The Theory of Economic Policy in English Classical Political Economy*, it harbors three broad research questions. The *first* asks why it is that the Smithian call for deregulation, and the associated belief in the workings of the invisible hand, may not always lead to salutary outcomes. The *second* queries how we should understand those "suitable institutions" that may prevent chaos; and the *third* investigates if, having identified what is needed, we also have a theory that may help in devising successful deliberate intervention, aimed at securing a high-performance economy.

Although the book will make frequent reference to the main forces that served to generate what has come to be known as the "Rise of the West," and to questions regarding why this experience has not been easily replicated in the Third World, empirical illustrations will in the main be drawn from Russian tradition. The reasons are simple. While the global financial crisis may offer plentiful input for a discussion on how legitimate self-interest may degenerate into pure greed, with devastating outcomes, it will fall far short of providing the combined insights inherent in Russia's long-term record of market-contrary governance, and in its proudly pronounced ambition, following the collapse of the Soviet Union, to implement radical "systemic change."

[3] Robbins, Lionel (1952), *The Theory of Economic Policy in English Classical Political Economy*, London: Macmillan, p. 56.

Recalling how firmly the latter project was rooted in a belief in the superiority of markets over physical planning and how firmly those advocating reform by way of "shock therapy" were united in calling for sweeping deregulation as a panacea to free up healthy market forces, we are faced with a serious need to explain how the actual outcome could be hyperdepression, hyperinflation, mass pauperization and a serious public health disaster.[4]

Part of the answer will surely rest in the fact that a variety of vested short-term interests were successful in corrupting the reform process and that measures actually implemented in consequence fell far short of visions projected by the reformers. More fundamentally, however, we shall argue that the design of such reform proposals that were associated with the "Washington Consensus," of which we shall have more to say later, reflected fundamental theoretical misperceptions that call for a reassessment of our understanding not only of central economic planning but also of the ideal of functioning market economy.[5]

Our ambition to undertake such reassessment shall proceed within the broad realm of new institutionalism, with particular emphasis on the interaction between formal rules, informal norms, and mechanisms of enforcement that has been suggested by Douglass North.[6] Seeking to explain the root causes of the global financial crisis and of the failure of post-Soviet deregulation to secure the envisioned efficiency gains, we shall navigate between the emphasis of new institutional economics on the role of transaction costs in determining choices between market and hierarchy, as laid out by Oliver Williamson,[7] and the fundamental argument of new

[4] Hedlund, Stefan (1999), *Russia's "Market" Economy: A Bad Case of Predatory Capitalism*, London: UCL Press.

[5] A somewhat similar argument on theoretical misunderstanding was made by Joseph Stiglitz in the spring of 1999, in the wake of the August 1998 Moscow financial meltdown. His claim, however, referred to a lack of appreciation of developments within modern economics, and a lack of understanding of the special conditions of transition. See Stiglitz, Joseph E. (1999), "Whither Reform? Ten Years of the Transition," available on http://siteresources.worldbank.org/INTABCDEWASHINGTON1999/Resources/stiglitz.pdf (accessed on October 1, 2009).

[6] North, Douglass C. (1990a), *Institutions, Institutional Change and Economic Performance*, Cambridge: Cambridge University Press. See also North, Douglass C. (1986), "The New Institutional Economics," *Journal of Institutional and Theoretical Economics*, vol. 142, no. 1, North, Douglass C. (1991), "Institutions," *Journal of Economic Perspectives*, vol. 5, no. 1, and North, Douglass C. (1993a), "Institutions and Credible Commitment," *Journal of Institutional and Theoretical Economics*," vol. 149, no. 1.

[7] Williamson, Oliver E. (1975), *Markets and Hierarchies: Analysis and Antitrust Implications*, New York: Free Press, Williamson, Oliver E. (1985a), *The Economic Institutions of Capitalism*, New York: Free Press, Williamson, Oliver E. (1985b), "Reflections on the New Institutional Economics," *Journal of Institutional and Theoretical Economics*, vol. 141,

economic sociology, originally suggested by Mark Granovetter, that motivation for action is embedded in social structures.[8]

The Russian experience is eminently suited to help in our search for answers to the questions posed here for one major reason: for centuries before the Soviet experiment, Russian tradition was consistently market-contrary, and economic performance in consequence was below par. Given that every instance of relaxing control and repression was followed by reversal of the *status quo ante*, at times after periods of major dislocation and predatory behavior, we may conclude that the "suitable institutions" called for by Lionel Robbins were never successfully put into place. Given, moreover, that repeated attempts to implement change were devised as deliberate top-down interventions, we have substantial empirical illustration of what types of obstacles may arise to impede success in such endeavors.

The more specific ambition of this text to capture the role of culture and history will expand on the author's previous ambition to formulate a theory of Russian path dependence.[9] It will do so by combining theories of historical institutionalism suggested by political scientists[10] with arguments by economists on historical economics and historical specificity.[11] Overall, the search will be implemented against a background of the old American school of institutionalism and of the broader evolution of social science over the past couple of centuries.

Before proceeding to the account proper, we shall expand on what was said in the preface about invisible hands and about Russian experience. On the former count, a review of the global financial crisis will be made and contrasted against earlier discussions on crises of capitalism. On the latter, a

no. 1, Williamson, Oliver E. (1996), *The Mechanisms of Governance*, New York: Oxford University Press.

8 Granovetter, Mark (1985), "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology*, vol. 91, no. 3. See also White, Harrison (1981), "Where do Markets Come From?," *American Journal of Sociology*, vol. 87, no. 3.

9 Hedlund, Stefan (2005), *Russian Path Dependence*, London: Routledge.

10 Thelen, Kathleen (1999), "Historical Institutionalism in Comparative Politics," *Annual Review of Political Science*, vol. 2, no. 1, Pierson, Paul (2000), "Increasing Returns, Path Dependence, and the Study of Politics," *American Political Science Review*, vol. 94, no. 2.

11 David, Paul A. (1993), "Historical Economics in the Long Run: Some Implications of Path Dependence," in Graeme D. Snooks (ed.), *Historical Analysis in Economics*, London: Routledge, David, Paul A. (1994), "Why Are Institutions the 'Carriers of History?' Path Dependence and the Evolution of Conventions, Organizations and Institutions," *Structural Change and Economic Dynamics*, vol. 5, no. 2, Hodgson, Geoffrey M. (2001), *How Economics Forgot History: The Problem of Historical Specificity in Social Science*, London and New York: Routledge, Hodgson, Geoffrey M. (2004), *The Evolution of Institutional Economics: Agency, Structure and Darwinism in American Institutionalism*, London and New York: Routledge.

review of Russian experience of post-Soviet reform will be added, focusing on how the freeing up of markets produced not increased value added but instead a hyperdepression and a host of social ills.

All will be done with the intention of setting the stage for approaching in more theoretical terms the fundamental conflict between legitimate self-interest and pure greed that constitutes the mainstay of the account as a whole.

INVISIBLE HANDS

Approaching the sensitive question of greed, we shall have to make a caveat. Although our purpose is not to moralize but to theorize, morality does play an important role in determining individual action. Much emphasis shall in consequence have to be placed on such processes of public norm formation that may inhibit or encourage individual self-interest seeking, beyond what Adam Smith once had in mind. In order to prepare the ground for incorporating such considerations, we shall start our journey in Hollywood.

When Greed Was Good

On December 11, 1987, the motion picture *Wall Street* was released in 730 theaters across the United States. It grossed $4.1 million over the opening weekend, and then went on to make a total of $43.8 million in North America.[12] Directed by Oliver Stone, it featured Michael Douglas as Gordon Gekko, a highly successful but totally unscrupulous corporate raider, and Charlie Sheen as Bud Fox, an ambitious young stockbroker who starts out idolizing Gekko and ends up in the hands of the Securities and Exchange Commission, accused of having leaked insider information.

The picture is relevant for our present purpose simply because it so admirably captures the ethics and morals – or rather lack thereof – among Wall Street movers and shakers in the heady days of the 1980s.[13] In one of its key

12 See http://www.boxofficemojo.com/movies/?id=wallstreet.htm (accessed on November 5, 2008).

13 With an uncanny sense of timing, in September 2009 Oliver Stone began shooting a sequel, titled *Wall Street 2: Money Never Sleeps*, which, given the events following September 2008, held every promise of attracting an even greater audience (http://www.nytimes.com/2009/09/08/movies/08stone.html, accessed on January 18, 2010). It was somehow symptomatic that while the original had acquired cult status on U.S. financial markets, when Stone wanted access to bank offices and trading rooms as background for shooting the sequel, he would have to turn to the Royal Bank of Canada.

scenes, Gekko addresses the board and shareholders of a fictitious company called Teldar paper:

> The point is, ladies and gentlemen, that greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit. Greed, in all of its forms, greed for life, for money, for love, knowledge, has marked the upward surge of mankind, and greed, you mark my words, will not only save Teldar paper, but that other malfunctioning corporation called the USA.[14]

An important reason that this statement has been so widely cited is that it evokes a long tradition of condemnation in Western culture, and especially in the Christian faith. Harking back to the biblical saying that "the love of money is a root of all kinds of evil,"[15] greed has been traditionally listed as one of seven deadly sins that may lead to eternal damnation.[16] In his *Summa Theologica*, which summarizes the arguments on most if not all points of Western Christian theology, Thomas Aquinas wrote that greed was "a sin against God, just as all mortal sins, in as much as man condemns things eternal for the sake of temporal things."[17]

What happened among theologians gradually also made inroads into the secular world. Beginning in the early fourteenth century, the time when the *Summa* was written, writers and painters began to develop the theme of the seven deadly sins, as a result of which the latter became ingrained into the broader cultural patterns of what would come to be known as Western civilization.

[14] See http://www.youtube.com/watch?v=JaKkuJVy2YA (accessed on November 5, 2008). Stone allegedly had found inspiration for Gekko's speech in a commencement address by U.S. financier Ivan Boesky, held at the UC Berkeley School of Business Administration on May 18, 1986. In his address, Boesky informed hopeful market operators that "Greed is all right; by the way, I think greed is healthy. You can be greedy and still feel good about yourself." Boesky himself would move on to serve two years in prison and pay a $100 million fine for insider trading, in addition to which he was barred for life from working in the financial markets. (See further http://www.answers.com/topic/ivan-boesky, accessed on November 11, 2008.)

[15] 1 Timothy 6:10.

[16] The Catholic Church draws a line between venial sins that are relatively minor and mortal sins that can lead to eternal damnation – unless either absolved through the sacrament of confession or forgiven through perfect contrition on the part of the penitent. The seven deadly sins are pride (*superbia*), greed (*avaritia*), lust (*luxuria*), envy (*invidia*), gluttony (*gula*), wrath (*ira*), and sloth (*acedia*).

[17] The *Summa* was written over the years 1265–1274 and was left unfinished when its author passed away. For a modern edition, see Aquinas, Saint Thomas (1981), *Summa Theologica: Complete English Edition in Five Volumes*, London: Sheed & Ward. The quote may in this edition be found in volume three, p. 1680.

An outstanding example is Dante Alighieri, whose magnum opus, the *Divina Commedia*, earned its author a prominent place in history.[18] The background to the emergence of this work is of particular importance here. At the time of its writing, Florence was badly afflicted by internal strife between families affiliated with the pro-Papal party, known as the Guelphs, and the party that supported the Holy Roman Emperor, the Ghibellines.[19] Having ended up on the wrong side in these conflicts, Dante was exiled and condemned in his absence to be burned should he ever return to Florence. His literary vengeance would secure him a place in the Hall of Fame of Western writers.

Throughout the *Commedia*, Dante consistently castigates greed, together with pride and envy, as the main causes of Florentine ethical and political corruption, and he does so with much gusto. In its first part, the *Inferno*, he is taken by Virgil on a tour of Hell, which is divided into nine concentric circles.[20] As he descends from one circle to the next, he encounters personages who in life had been high and mighty but in death are suffering eternal punishment. It is in the fourth circle that he meets those, including well-known popes and cardinals, who had committed the deadly sin of greed and are now so tortured and transfigured that they are barely recognizable. (Note how Dante, in his vivid and merciless descriptions of their eternal torment, himself may have committed the deadly sin of lust.)

The impact of Dante's portrayal of the deadly sins has been profound. Unsurprisingly, leftist writers have been particularly fond of citing his lustful depiction of the eternal sufferings of bankers in the Inferno. Yet, from a social science perspective, it is imperative not to succumb to the lures of

[18] The *Commedia*, which was Dante's own short title, consists of three parts – *Inferno*, *Purgatorio*, and *Paradiso* – that were published separately in, respectively, 1317, 1319, and 1320. It was only in 1472 that the three were published jointly, and only in the mid-sixteenth century that the work appeared as the *Divina Commedia*.

[19] The names are of German origin, having emerged during struggles between the dukes of Bavaria (Welfs) and the Hohenstaufens of Swabia (from Waiblingen). They were introduced into Italian in the twelfth century, during the reign of Frederick Barbarossa. The respective affiliations were partly determined by wealth, with mercantile interests tending to side with the Guelphs, who were in opposition to the Imperial power, but practical considerations also played a part. Cities that were under threat from the Papal States would side with the Ghibellines, and those that felt Imperial pressure would side with the Guelphs. After the final defeat of the Ghibellines, in 1289, the Guelphs broke up into White and Black factions that started fighting each other.

[20] Four of these are devoted to mortal sins; the second to lust, the third to gluttony, the fourth to greed, and the fifth to wrath. At the very bottom of the ninth circle we may find those guilty of the most infamous cases of treachery in history, namely Judas, the betrayer of Christ, and Cassius and Brutus, the betrayers of Julius Caesar.

indiscriminate accusations of greed, understood as an inherent moral quality that dictates economic behavior. We do not, after all, live in an entirely Hobbesian world that is marked by the war of all against all.

This is certainly not to say that greed is good, or that Gordon Gekko was right in claiming that it "captures the essence of the evolutionary spirit." What it does say is that actions that are being construed as driven by greed must be viewed as consequences of systemic defects, of market imperfections that place actors in situations of temptation that – to some, albeit not to all – may prove to be simply irresistible.

The core of the matter concerns the crucial role of self-interest, without which it would make little sense to speak of market economy. As will be shown in subsequent chapters, thinkers from Adam Smith onward have been conscious that some restraints need to be in place here. More recently, Kenneth Arrow has noted that "ethical elements enter in some measure into every contract; without them no market could function."[21] Similarly, James Buchanan wrote that "Life in society, as we know it, would probably be intolerable if formal rules should be required for each and every area where interpersonal conflict might arise."[22] The general need of well-functioning markets for what we shall refer to as a "golden rule" of morality has been well formulated by Jean-Philippe Platteau, who argued that "the pervasive presence of generalized morality in a society can prevent the enforcement costs of the rules of honesty from being excessively high."[23]

With some seeming regularity, financial markets in particular tend to shift into a mode of overdrive where legitimate self-interest that respects the golden rule degenerates into pure greed, with fatal consequences. It is the task of regulators to fine-tune intervention so that such lapses can be precluded – without stifling the pursuit of legitimate self-interest. The reality, however, that was reflected by Oliver Stone in the screen presentation of Wall Street was rife with illustrations of just how difficult that task can be. Once the herd mentality of brokers and corporate executives eager for short-term gain at any risk and cost has taken over, the outcome is bound to be complete abandonment of restraint, and in the end disaster.

As an extreme illustration of what regulators and oversight agencies have been tasked with preventing, we may usefully expand on the case of

[21] Arrow, Kenneth J. (1973), *Information and Economic Behavior*, Stockholm: Federation of Swedish Industries, p. 24.
[22] Buchanan, James M. (1975), *The Limits of Liberty – Between Anarchy and Leviathan*, Chicago: Chicago University Press, p. 118.
[23] Platteau, Jean-Philippe (1994), "Behind the Market Stage Where Real Societies Exist – Part II: The Role of Moral Norms," *Journal of Development Studies*, vol. 30, no. 3, p. 756.

Bernard Madoff. He served for many years on the board of NASDAQ and in the process built a solid reputation on Wall Street, but in the end he could not resist temptation. Using his investment firm, Bernard L. Madoff Investment Securities LLC, as a platform, he proceeded to build the most spectacular Ponzi scheme in the history of financial fraud. When he was arrested by the FBI, on December 12, 2008, banner headlines claimed that his investors, including several major European banks, had lost a staggering total of $50 billion.[24] Even more astounding were allegations that over a period of many years, whistleblowers had tried to push the Securities and Exchange Commission into taking action, but to no avail.[25] Madoff had, quite obviously, been above suspicion.

The Madoff case may certainly be dismissed as one of outright criminal fraud, with little relevance to the more routine tasks of financial oversight. There is, however, no shortage of other illustrations that show how difficult those tasks may be. In order to drive home how greed may serve to inflate financial bubbles, which in the end also cause massive losses, it may suffice here to recall toxic cases like those of Enron, WorldCom, and Arthur Andersen.[26]

Enron was a Houston-based energy company created in 1985. When it filed for Chapter 11 bankruptcy protection, on December 2, 2001, it was the seventh largest corporation in the United States, with 21,000 employees in more than forty countries. Most important, right up until the very end it was also the darling of financial market operators who were mesmerized by a stock that traded at fifty-five times earnings.[27] Its bankruptcy broke all previous records in losses, and the revelations that followed, of highly creative accounting practices, caused a huge scandal.

Less than eight months later, on July 22, 2002, another darling of the financial markets, telecom giant WorldCom, with 85,000 employees in

[24] For an in-depth account of the story as a whole, which in the end finished at $65 billion and won Madoff a 150-year prison sentence, see http://www.ft.com/indepth/madoff-scandal (accessed on July 15, 2010).

[25] http://money.cnn.com/2009/02/04/news/newsmakers/madoff_whistleblower/index.htm (accessed on October 1, 2009). For an interview with one of those who tried long and hard to expose the scam, see http://www.guardian.co.uk/business/2010/mar/24/bernard-madoff-whistleblower-harry-markopolos (accessed on July 15, 2010).

[26] In a broad and harshly critical background to these events, Paul Krugman asks "how it was possible for a country with so much going for it to go downhill so fast," and argues that it is "a story about leadership – incredibly bad leadership, in the private sector and in the corridors of power" (Krugman, Paul (2003), *The Great Unraveling: Losing Our Way in the New Century*, New York: Norton, p. xvi).

[27] When Enron collapsed, it had just been named "Most Innovative Company in America" for the sixth consecutive year by *Fortune Magazine* and been ranked in the top quartile in the same magazine's list of "100 Best Companies to Work For."