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**Analysis of political economy, international political economy, globalization and its importance to public finance**

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**Abstract.** The purpose of this paper is to provide an analysis of the discipline of political economy, international political economy and their respective historical developments. The paper will then focus on globalization and evaluate the strength and weaknesses of the policy to globalize. Further analysis will be conducted to show the importance of the topic of globalization as it relates to public finance. Rosen & Gayer (2014), Sackery, Schneider & Knoedler (2016), Marlin-Bennett (2017), Ravenhill (2008) and Weingast & Witman (2006) will provide insights into the development of the discipline and its modus operandi. The historical development of the discipline will be provided for by Ingram (1915) and the aforementioned authors will also provide insights into the weakness and strengths of the policy to globalize. Garrett & Mitchell (2001) and Kumar (2006) will provide additional insights into the importance of globalization as it pertains to public finance.

**Keywords.** Political economy, International political economy, Globalization, Public finance. **JEL.** F50.

## 1. Introduction

Through the many years of its development the discipline of political economy has evolved and stands by itself as a discipline distinguished from mainstream economics. Hence, according to Rosen & Gayer (2014), “political economy is the field that applies economic principles to the analysis of political decision making.” (p.108).

Sackery, Schneider & Knoedler (2016) provide a further detailed explanation of political economy in the following quotation:

Political economy...is more concerned [than mainstream economics] with the relationships of the economic system and its institutions to the rest of the society and social development. It is sensitive to the influence non-economic factors such as political and social institutions, morality, and ideology in determining economic events. It thus has a *much broader focus* than [mainstream] economics. (p.vii).

The modus operandi of political economy is then a collection of methodologies that are applied to the analysis of economic systems, political decision making, political behavior and institutions.

Weingast & Wittman (2006) in the *Oxford Handbook of Political Economy* provide for a succinct description of various methodologies used in political economy and hence:

“Sometimes was viewed as an area of study (the interrelationships between economics and politics) while at other times it was viewed as a methodological

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approach. Even the methodological approach was divided into two parts—the economic approach (often called public choice) emphasizing individual rationality and the sociological where the level of analysis tended to be institutional” (p.3-28).

Therefore, the analysis focuses and narrows down on the individual. Rosen & Gayer (2014) explain that, “Political Economy models assume that people view government as a mechanism for maximizing self-interest.” (p.108). Weingast & Wittman (2006) extend this description to include evolutionary games and hence, “The individual is motivated to achieve goals (usually preference maximization but in evolutionary games, maximization of surviving offspring)” (p.3-28). A further explanation is provided on the underpinnings of the theory and the mathematical and statistical methods that are used. “The theory is based in mathematics (often game theoretic), and the empirics either use sophisticated statistical techniques or involve experiments where money is used as a motivating force in the experiment” (p.3-28).

As the *modus operandi* is based on statistical analysis and the availability of data is then a prerequisite for theoretical development, much of the theory has been refined to analyze advanced industrial countries. Hence, according to Weingast & Wittman (2006) “Our most comprehensive knowledge is about the advanced industrial democracies in general and legislatures in particular, where the great number of observations (of vote, party affiliation, etc.) allow for an extensive testing hypotheses and considerable refinement theory” (p.3-28). This is not to say that the discipline has not matured from its core area of research in recent years. Indeed, the discipline has developed to include a variety of political systems as the availability of cross-country data and information has increased. Therefore, “As motivating reason to choosing the size of nations as our prime example of the spread of political economy is that rational choice models have been unfairly accused of dealing with “epiphenomena” such as voting rather than with “deeper and more substantive” issues. The size and wealth of nations clearly passes the gravitas test (p.3-28).

The concept of international political economy is then similar to that of political economy with international political economy (IPE) being the study of cross-border transactions. Furthermore, this term later evolves into global political economy (GPE). Hence, according to Renee Marlin-Bennett (2017), “The concept of international political economy (IPE) encompasses the intersection of politics and economics as goods, services, money, people and ideas move across borders.” (p.1-36). Moving on to Global Political Economy (GPE), Marlin-Bennett (2017) asserts that, “The shift signaled a recognition that what happens is not just about interaction between states and that the global political economy includes many different kinds of actors. Rulemaking for the global order happens in a private as well as a public setting.” (p.1-36)

Hence, we see that the field of international political economy now more formally known as global political economy is quite substantive. Therefore, a careful study of the discipline requires that it be broken down into manageable chunks. Thus, according to Thomas Oatley (2011), “Typically, the global economy is broken into four such issue areas: the international trade system, the international monetary system, multinational corporations (or MNCs) and economic development.” (p.1-20). The study of the global economy using the *modus operandi* of international political economy is then more than a descriptive discipline that aims to describe the government policies and contemporary developments in the above mentioned four areas.

The focus is then on the consequences of these policies. Hence, according to Oatley (2011) “As a consequence two abstract and broader questions typically shape the study of trade, money, MNCs and development. First, how exactly does politics shape the decisions that societies make about how to use the resources that are

available to them? Second what are the consequences of these decisions?” (p.1-20). To answer these two questions many scholars have devised theories. Therefore, Oatley (2011) asserts that, “Three traditional schools of political economy-the mercantilist school, the liberal school, and the Marxist school-have shaped the development of these theories over the last 100 years” (p.1-20). (Please refer to Appendix I for an insightful analysis of the three traditional schools of IPE).

### 2. Historical development of political economy and international political economy

The theoretical basis of the discipline can be traced all the way back to ancient times. Hence, according to John Kells Ingram (1915), “The history of economic inquiry is most naturally divided into three great periods of (1) the ancient (2) the medieval, and (3) the modern worlds.” Of-course the most elaborate and well known of the Greeks was Plato who sets out describe his version of the ideal state. Therefore, according to Ingram (1915), “In it the idea of the subordination of the individual to the state appears in its most extreme form.” (p.338). Although another great work relating to the discipline is found in these ancient times. Xenophon and in his treatise entitled *Economicus* we find although limited a practicality. “But there is to be found in his writings a remarkable body of sound and valuable thoughts on the constitution and workings of the social organism” (Ingram, 1915). Further Greek thinkers of note are of-course Aristotle, “who criticized Plato’s conception of communal ownership and placed the state in the role of guarantor of private property in *The Politics* (Marlin-Bennett, 2017, 1-36). Among the earliest of thinkers in this time is the Indian author of *Artashastra*, a book on statecraft.” (Marlin-Bennett, 2017, 1-36). The middle ages and the modern era saw many a great works produced from a variety of perspectives. Ingram (1915) explains that, “The close of the Middle Ages as Comte has shown, must be placed at the end not of the fifteenth the thirteenth century.”(p.696). Furthermore, the modern times are divided into three phases. “I. During the fourteenth and the fifteenth century [...] II. In the second phase of the modern period which opens in the beginning of the sixteenth century [...] III. And the last phase which coincides with the eighteenth century.” (p.696)

From the Islamic scholars, “Ibn Khaldun (1332–1406) who wrote about the relationship between governing structures and productivity of people (Ibn Khaldun 1967). Another Muslim scholar of this era, Al-Maqrizi (d. 1442), analyzed governmental policies, including monetary policy.” The well-known Italian writer “Niccolo Machiavelli (1469-1527), generally seen as a political theorist, was mindful of the relationship between the state and the economy as well, at least in the sense that a primary role of the prince or of a republican government is to protect private property”. Furthermore, we find that the works of St. Thomas Aquinas are of critical importance, as they mark a period of scholarship providing for a synthesis of Greek thought by both the Muslim and Christian scholars and hence, “the political doctrines of Aristotle reproduced with a partial infusion of Christian elements”. (Marlin-Bennett, 2017, p.1-36).

Last but not the least Ingram (1915) asserts that then it was a French writer who produced the first systematic work:

“The first systematic treatise on our science which proceeded from a French author was the *Traité de l’Économie Politique*, published by Montchrétien de Watteville (or Vasteville) in 1615. The use of the title, says Roscher, now for the first time given to the science, was in itself an important service, since even Bacon understood by “Economia” only the theory of domestic management.” (p.1917).

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Therefore, following the first systemic treatise then a variety of works were produced towards the end of the 16<sup>th</sup> century and in the 17<sup>th</sup> and 18<sup>th</sup> century. Many a prolific writer emerged such as; Richard Cantillon, Adam Smith, David Ricardo, Jean-Baptiste Say and John Stuart Mill. Onwards to the physiocrats such as Francois Quesnay, professors of political economy such as Thomas Malthus, Karl Marx and towards the mathematical development of the discipline we now know as 'economics' with Alfred Marshall.

As introduced earlier the traditional theories of international political economy have been developed in three schools of thought, mercantilism (or nationalism), liberalism and Marxism. As Oatley (2011) explains, "Mercantilism is rooted in 17<sup>th</sup> and 18<sup>th</sup> century theories about the relationship between economic activity and state power." (p.1-20) Even though the mercantilist tradition is large and varied, both classical and modern mercantilist adhere to three central propositions. Hence, "First the classical mercantilists argued that national power and wealth were tightly connected. [...] Second, the classical mercantilists argued that trade provided one way for countries to acquire wealth from abroad. [...] Third, the classical mercantilists argued that some types of economic activity are more valuable than others." (p.1-20)

As our earlier analysis indicates the 18<sup>th</sup> century saw the advent of many a political writer in the discipline of political economy. It was also during this period that the second school of tradition political economy Liberalism arose as a challenge to the dominant thought of mercantilism. Two of the most prolific writers of the liberal school of thought were Adam Smith and David Ricardo who challenged the three central propositions of the mercantilist school.

Hence, Oatley (2011) provides a succinct description of the liberal arguments against mercantilism:

"First, liberalism attempted to draw a line between politics and economics...argued that the purpose of economic activity was to enrich individuals not to enhance the state's power. Second liberalism "argued that...countries gain from trade regardless of whether the balance of trade is positive or negative. [...] countries are made wealthier by making products that they can produce at a low cost at home and trading them for goods that can be produced at home only at a relatively high cost. Thus, ... governments should make little effort to influence the country's trade balance or to shape the types of goods the country produces. (p.1-20)

Marxism was the third school of thought that rose in the 18<sup>th</sup> century. The work of Karl Marx can be viewed primarily as a critique of capitalism. Marx lays out the central conditions of capitalism and then predicts that capitalism would lead to a revolution that would do away with private property, private property being the central tenements that capitalism supported. The Marxist critique was in complete contrast to the view of liberal thought process and the mercantilist. While the liberal thought process focused on the market and the mercantilist focused on the state, Marx focused on big corporations. Hence, Marx provides the central conditions to capitalism, "two central conditions: the private ownership of the means of production (or capital) and wage labor." Furthermore, he provided for the three dynamics that would drive a revolution away from capitalism. Thus, "... natural tendency towards the concentration of capital [...] capitalism is associated with the falling rate of profit [...] capitalism is plagued by an imbalance between the ability to produce goods and the ability to purchase goods" (Oatley, 2011, p.1-20).

Hence, these three traditional schools of thought provide for different answers as to how resource allocation occurs and provide an important framework for the

application and analysis of policy. This Trichotomy as explained by John Ravenhill (2007) introduces further terms such as; Liberalism, Ontological liberalism, Deontological Liberalism, Realism, Statism, Mercantilism, Nationalism, Marxism, Structuralism, Radical and Critical.

### 3. Analysis of the strengths and weaknesses of globalization as a public policy

Implicit in the term “globalization” rather than the older “internationalization” is the idea that we are moving beyond the era of growing ties between state and are beginning to contemplate something more than the existing conception of state sovereignty. But this change needs to be reflected in all levels of our thought, especially in our thinking of ethics and our political theory (Singer, 1950).

The rate of globalization has increased at a phenomenal rate. During the past 50 years we have seen many governments that have progressively eliminated policy barriers to trade. The elimination of these barriers to has led to a decrease in both the transportation cost and the telecommunication cost. This fall in cost has consequently led to the creation of division of labor by making it cheaper to engage in import and export of inputs and organize and manage production on a global scale. Although there have been many benefits to globalization both for advanced economies and developing economies, there have also arisen problems. Hence, in last 15 years there has been a political backlash against globalization and critiques such as inequality, labor standards and the prioritization of commercial interests over others have ensued. (Oatley, 2011, 47-72)

To understand why the world has proceeded towards globalization we have to understand the impetus behind trade and what is it about trade that leads to globalization. The advantage and strength of trade is that it enables to achieve gains that would not be possible in a closed economy. Furthermore, we realize these gains due to the concepts of absolute advantage first explored by Adam Smith, the concept of comparative advantage introduced by David Ricardo, the Hechsher-Ohlin model and the Stolper-Samuelson Theorem. Hence, the framework that is used to assess the gains in trade are the partial equilibrium model and general equilibrium mode. Where the partial equilibrium model focuses on a single commodity and how the production and consumption of a commodity change with respect to trade. While the general equilibrium model focus on the whole economy and how the production and consumption of all goods change in response to trade. (Oatley, 2011, 47-72).

Both the partial equilibrium model and the general equilibrium model point us towards the gains that arise from trade. Hence, partial equilibrium analysis reveals that there arises a gain in welfare and that society enjoys a greater increase in welfare with trade then without trade. Furthermore, individuals as consumers capture these gains and it allows to consume more products for the same amount of money than they can without trade. This translates into the fact that every dollar that the consumer earns goes further in the market place and hence raises the consumers income. General equilibrium analysis reinforces the principal of comparative advantage that, all countries gain when they specialize in goods they produce well, and trading for the goods that they produce less well. Therefore, country specialization occurs in goods that rely heavily on the factors of production that they hold in abundance and exchanging them for goods that rely heavily on the factors of production that are scarce in their economy (Oatley, 2011, 47-72).

Once we have understood why and how countries gain from trade we can begin to look at the consequences and controversies that surround the policy to globalize. There is vast amount of literature that documents the gains from trade both in

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developing nations as well as advanced economies. Both developing countries as well as advanced nations gain in terms of increase in wage structures. Although this is the case many a problem has arisen because of globalization such as; the rise in poverty and inequality, exploitation of labor and poor labor standards, the prioritization of commercial interest and the effect of trade on the environment. Recent analysis has revealed these to be true and that the policy measure to dampen these effects have not kept up pace with the phenomenal rate at which the world has globalized. Therefore, these negative effects have weakened the policy measure to globalize and hence the backlash in recent years.

As mentioned earlier there are two questions that arise out of the study of the global economy through the lens of political economy, pertaining to the political decision about resource allocation and the consequences of these decisions. Hence, further exploration of these two questions yields that these decisions have both “welfare consequences” and “distributional consequences”. Thus, the research tradition is further divided into two traditions, “explanatory studies which relate more closely to the first question...” why questions” [...] Evaluative studies, which are related to the second abstract question, are oriented toward assessing policy outcomes [...] A welfare evaluation is interested primarily in whether a particular policy choice raises or lowers welfare.” (Oatley, 2011, 1-20).

We see that the study of welfare consequences and distributional consequences falls under the umbrella of public finance. Hence, according to Rosen and Gayer (2014), welfare economics is “The branch of economics theory concerned with the social desirability of alternative economics states.” (p. 3-50). We see that there are welfare issues that arise due to globalization and hence can be termed as externalities, “A situation when the activity of one entity directly affects the welfare of another in a way that is outside the market mechanism.” (p.3-50). Furthermore, the framework of the normative welfare system, makes us ask three questions in regarding public policy. Therefore, “will it have desirable distributional consequences? Will it enhance efficiency? Can it be done at a reasonable cost?”.

From our above analysis we do see that there are distributional costs to the proposed public policy in terms of inequality, but we also see that the public policy enhances efficiency due to specialization of labor, furthermore it may be done at a reasonable cost since the public policy in itself brings in revenue and sets the basis for global taxation. Distributional considerations are hard to assess for public project and if the Hicks- Kaldor criterion is used then, “A project should be undertaken if it has a positive net present value, regardless of the distributional consequences” (Rosen & Gayer, 2014, p.147-173). Correcting for distribution always proves a problem even if the government tries to work in the background to correct distributional issues in a cost-effective manner. Although this does not mean that correcting for distribution is not in effect. There are a vast amount of literature that addresses value judgements such as the debates between the welfarist and the egalitarian. Furthermore, policy programs such as retraining for labor, strengthening of social security, providing information to both employers and employees, regulations on labor standards are examples of programs that have been proposed to deal with distributional issues.

Although it is documented that it is a tough for the government to correct for distributional issues, analysis has revealed that there has indeed been a shift towards a welfare state documented especially in the OECD countries (Garrett & Mitchell, 2001, 145-177). Hence, from the point of view of many this shift to the welfare state has been traced back to the rapid increase of internationalization and globalization. Hence, then globalization has in itself provided the government with the incentive to

increase their activity in order to stem the tide of the distributional effects of globalization.

### 4. Globalization and its importance to public finance

As briefly mentioned above the distributional and welfare consequences make globalization an important topic in the study of public finance. This is because the tools of public finance are used to analyze both the distributional and welfare consequences and to decide what course of action is desirable. Furthermore, in open economy where the capital is completely mobile across countries opens up the economy to the possibility of Capital Taxation in a Global Economy. Hence for US that has a large capital market it is imperative that policy makers take globalization into account. Hence, “policymakers who ignore globalization will overestimate their ability to place the burden of taxation on owners of capital” (Rosen & Gayer, 2014, 308).

There are further reasons why globalization is important for the field of public finance. As globalization is a policy measure and then requires government spending such as maintaining an infrastructure that supports the policy to globalize. Hence, this is important for many a developing country, “they may need to take undertake major public expenditure reforms to enhance competitiveness in the global market and reduce structural unemployment” (Kumar, 2006, p.96-86). Furthermore, tax competitiveness is another reason why globalization is important to public finance. This may lead to a fall in government revenues especially for developing countries, because of a tax competitiveness, foreign direct investment, tax havens, portfolio investments, electronic commerce. Hence, globalization can be seen demand an increase in government regulation while at the same time reducing the government capacity to intervene due to a reduction in the availability of financial resources (Kumar, 2006, p.96-86). Hence, the tax system for both developing and advanced countries will need to be overhauled due to globalization and this has taken place in the recent years. There has been a marked move towards policy harmonization behind national borders, prevention of negative externalities that undermine the countries security and stability and the emergence of modern public finance which blends the state of external and domestic policy demands. The new challenges that have arisen have been met through mobilizing and public and private resources towards making international cooperation behind national borders to happen (Kumar, 2006, p.96-86).

### 5. Conclusion

The paper provides for a succinct introduction to the modus operandi of political economy, international political economy and in more recent times the global political economy. The historical development of the discipline is mapped out and we trace the development through the three main periods, ancient, medieval and modern. Furthermore, analysis of the three main schools of thoughts is provided for and we examine that policy to globalize arises from the impetus to trade and principles of absolute advantage, comparative advantage and the HO model. Furthermore, we examine that there do arise gains from trade but at the same time there are also distributional issues that arise from globalization. Hence, the tools of public finance are used to evaluate the distributional consequences. Furthermore, we reach a conclusion that globalization and internationalization has caused many countries to shift towards being a welfare state to stem the negative effects of globalization.

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