'Redefining Socialism: Karl Polanyi and the Democratization of Finance*

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Redefining Socialism: Karl Polanyi and the Democratization of Finance

The Global Financial Crisis that began in 2008 has reopened a set of questions that most social scientists had relegated to the dustbin of history. Debates about secular stagnation in advanced economies that had been fashionable in the 1930’s have reemerged. Even more striking has been the emergence of books carrying titles such as “Does Capitalism Have a Future?” The idea that was popular at the end of the Cold War that “liberal capitalism” represented the “end of history” now seems amazingly quaint since the future of capitalism now requires a question mark.

But the peculiarity of the present is that the meaning of the two master categories of capitalism and socialism are both tangled in webs of ambiguity. If capitalism is the name for the current Chinese autocratic regime, the advanced welfare states of the Nordic countries, as well as kleptocratic regimes in sub-Saharan Africa, it lacks something in specificity. This is why recent scholarship has sought to understand particular “varieties of capitalism”. However, a case can be made that even this effort is a misguided effort to hold onto a concept that is no longer useful.

But the problems with the concept of socialism are even more serious. Given the obvious failure of the Soviet model, there is little consensus about what an actual socialist society should look like. Current efforts to envision such a society cover a huge range; they extend from ideas of market socialism on one end to participatory economies in which markets have been almost

entirely eliminated at the other. But none of these visions have established that such a form of social organization would be feasible and economically productive. And, of course, hanging over the question of the feasibility of socialism is the difficulty of envisioning a path that might carry us from here to there. The experience of the 20th century had the effect of casting severe doubt on both revolutionary and reformist paths to socialism.

A possible path out of these ambiguities is to consider Karl Polanyi’s rather idiosyncratic definition of socialism as “the tendency inherent in an industrial civilization to transcend the self-regulating market by consciously subordinating it to a democratic society”. Polanyi proposed this definition as an alternative to the Marxist definition of socialism and as an effort to displace the conventional capitalism/socialism binary. Polanyi is suggesting that socialism is something that is already present in market societies, so one might think of socialism not as a fundamentally different form of society but as a variable linked to the extent to which the market has been subordinated to society.

The project of this paper is to elaborate this alternative Polanyan conception of socialism and to use it to rethink debates over the transition to socialism. The paper is organized in five parts. The first elaborates what Polanyian socialism might mean in the 21st century and explains why the democratization of finance is central to this project. The second analyzes the failures of the existing financial system, particularly in the U.S., that make it vulnerable to reform efforts. The third proposes design principles for financial reform. The fourth outlines a strategic reform agenda. The fifth is a conclusion that shows the way in which this approach could overcome the historic barriers to a socialist transition.

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Part 1: The Vision.

In Polanyi’s definition, socialism is an inherent tendency in an industrial civilization. But we know that early in his intellectual development, Polanyi had staked out an intellectual position that was deeply critical of deterministic accounts of human history. In fact, Polanyi goes out of his way in The Great Transformation to make Robert Owen, the early English socialist, the hero of his story because of his early recognition that society could not be run by market principles alone. Owen had been dismissed as a Utopian Socialist by Marx and Engels for his failure to recognize that socialism could only be a real possibility after a period of capitalist development had brought society’s productive forces to maturity. In celebrating Robert Owen, Polanyi is suggesting that England might have chosen a different developmental path than reliance on self-regulating markets as early as the 1830’s and 1840’s.

Polanyi’s argument is that the possibility of socialism is present from the first moment of industrial development. However, there is a world of difference between the tendency being present and socialism being realized; the latter requires conscious action by political actors. The Great Transformation emphasizes that the deep crisis of industrial civilization gave rise in the 1920’s and 1930’s to fascist social movements that deliberately destroyed democratic institutions. So it is a central part of Polanyi’s worldview that the triumph of democracy is by no means inevitable; there is no guarantee that efforts to subordinate the market to democratic politics will succeed.

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In the final pages of *The Great Transformation*, Polanyi gives some additional specificity to his vision of socialism. He explicitly argues that subordinating the market to democracy will not reduce the sum of human freedom. On the one side, the rich will lose some of their autonomy in deciding where or in what form to hold their portfolios. But this will be more than offset by the increased freedom of most people who will no longer be subject to the tyranny of market forces in their everyday lives.

“The comfortable classes enjoy the freedom provided by leisure in security; they are naturally less anxious to extend freedom in society than those who for lack of income must rest content with a minimum of it.” [p. 262]

But Polanyi goes on to acknowledge that by dismantling the institutional separation of politics and economics that had been characteristic of the liberal era created the possibility of losing freedom. However, he also argues that these dangers could be overcome by creating new safeguards. In a passage that might well have been a kind of peace offering to his fiercely anti-Soviet brother, Michael, he wrote:

In an established society the right to nonconformity must be institutionally protected. The individual must be free to follow his conscience without fear of the powers that happen to be entrusted with administrative tasks in some fields of social life. Science and the arts should always be under the guardianship of the republic of letters. Compulsion should never be absolute, the ‘objector’ should be offered a niche to which he can retire, the choice of a ‘second-best’ that leaves him a life to live. Thus will be secured the right to nonconformity as the hallmark of a free society.

Another angle on Polanyi’s socialism is his enthusiasm in the 1920’s for G.D. H. Cole’s idea of Guild Socialism. Cole envisioned a system of dual power in which there would be both a parliament elected territorially and a representative body that was elected by the worker-

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7 *GT*, 262.
9 *GT*, 263-264.
owners of the various economic enterprises in the society. The most important economic
decisions would be hashed out in negotiations between these two peak representative bodies.
Cole was obviously seeking to avoid the centralization of authority that occurred in the Soviet
Union while preserving many of the positive elements of parliamentary democracy. These ideas
also influenced Polanyi’s contribution to the socialist calculation debate in the 1920’s.

Perhaps the best way to understand Polanyi’s definition of socialism as subordinating the
market to democratic society is by seeing it as a critique of Marx and Marxism. Polanyi was
acutely aware that Marxism had emerged historically amidst other political currents that
embraced visions of radical democracy or the self-conscious destruction of state power. While
these other currents were preoccupied with the problem of how to assure that government would
be responsive to the public will after the revolution, Marx and Engels insisted that this was the
wrong question. They argued that once the class power of the bourgeoisie was destroyed, there
would be no material basis for an oppressive state. This was the foundation for their claim that
state power would simply wither away since it was no longer required to support a system of
exploitation.

Karl Polanyi clearly rejects this view. His main focus in The Great Transformation is
his attack on market liberals who argue that the state’s role in society can be kept to a bare
minimum by relying on market self-regulation. But in mounting his critique of this idea as
utopian, his attacks often challenge Marxism as well. In the final pages of the book, he writes:

‘No society is possible in which power and compulsion are absent, nor a world in which
force has no function. It was an illusion to assume a society shaped by man’s will and
wish alone.’ ¹¹

¹¹ GT, 266.
In short, the state—Weber’s monopoly on legitimate violence—is not going to disappear, so the issue of bringing the state under control of society will continue to exist even after the bourgeoisie has been dispossessed.

But Polanyi’s objection is even deeper; he dislikes the centralized economic model that was at the heart of Soviet socialism. In his contribution to the socialist calculation debate in the 1920’s, Polanyi sought to preserve a system of prices that was not administered centrally. He envisions rather a system in which prices would be negotiated between worker-owned enterprises and purchaser cooperatives that were both run on a democratic basis. In other words, Polanyi sees the existing institutions for defending the interests of the working class such as trade unions and consumer cooperatives as building blocks of a socialist society in which power over key economic decisions would be widely diffused rather than concentrated in some powerful administrative bodies.

The idea of negotiating prices on a decentralized basis reflects Polanyi’s generally positive view of markets. In his later writings, Polanyi consistently defends markets as useful institutions that bring together buyers and sellers even while he rejects the idea of a market society which relied on an interlocking system of “self-regulating” markets. This position is also sharply distinct from Classical Marxism that was unrelentingly hostile to market exchange. To be sure, Polanyi is acutely aware that market exchanges are often one sided with one party receiving far less than they are due. But he sees these structured inequalities not as inherent in markets but rather to be a consequence of the legal and political arrangements in which those markets are embedded. It followed logically that a socialist movement could use reforms of labor law and unemployment insurance to equalize bargaining power so that even with continuing private ownership, employees would receive a fair compensation for their efforts.
One way to summarize Polanyi’s views is that he sees the Marxist vision of socialism as excessively focused on the binary that property is either owned privately or by the collectivity. Polanyi’s view is closer to the understanding of property as a bundle of different rights that can be limited or restricted, making possible hybrid forms that combine public and private elements. So, for example, Germany’s laws on co-determination that recognize workers as stakeholders in the enterprise represents a significant shift in property relations, albeit one that retains a significant element of private ownership. Hence, for Polanyi, democratizing society is a process and there are no shortcuts that would guarantee a successful outcome. And as we know from the reversals of socialist property that occurred in Eastern Europe and the former Soviet Union, that expropriation of the bourgeoisie is hardly any kind of guarantee since it can also be undone.

In sum, in Polanyi’s vision, there is no bright line separating the existing economic arrangements from the arrival of socialism. Rather, extending democratic control over the market is a process that would unfold over many decades with the distinct possibility of reversals and detours. At the beginning of the process, private property would continue to exist, but there would be incremental restrictions on the prerogatives exercised by property holders. To increase the fairness of the labor market, for example, employees would have extensive trade union rights and access to public benefits. Labor would continue to be bought and sold on the market, but the illusion that labor was simply another commodity whose price is determined in the market would be overcome.

Polanyi leaves the question of what socialism will ultimately look like open. It is possible that after a few generations, private property in the means of production would disappear as firms became employee-owned cooperatives. Alternatively, the remaining profit-
oriented firms might be sufficiently tamed that they are no longer seen as an irritant that interferes with the society achieving its shared goals.

Some might argue that Polanyi’s view of socialism is classically Social Democratic in that it is evolutionary and democratic and it leaves open the precise arrangements that will exist in the future. There is an element of truth in this claim; Sheri Berman has shown the strong resonance between Polanyi’s views and the path that the Swedish Social Democrats pursued in the 1930’s. But Berman goes on to argue that one has to distinguish the initial outlook of Swedish Social Democrats in the 1930’s and 1940’s from the mindset that was characteristic of European Social Democracy in the 1960’s and 1970’s. In their heroic period, the Swedish Social Democrats were trying to create a social order that was neither the centralized socialism of the Soviet Union nor a kinder and gentler form of capitalism. But as Social Democracy became institutionalized in Sweden and other countries, its theorists lost touch with their radical origins and most of them became satisfied with the idea of attaching more generous forms of social provision to an economy organized around private ownership of the means of production. It would be wrong to associate Polanyi’s view of socialism with this domesticated form of Social Democracy.

But how does Polanyi help us think about the transition to socialism? Erik Wright has clearly conceptualized the problem of transition. He argues that Classical Marxism provided all of the elements of a coherent theory of both why and how a socialist transformation would occur, but he also acknowledges that the Marxist argument is deeply flawed. Wright goes on to argue that no other theory of transformation has emerged since Marxism. The argument here is that a more persuasive theory of socialist transformation can be elaborated within a Polanyian

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framework. While Polanyi’s writings provide us with very little guidance as to how the full subordination of the market to democratic politics could actually be achieved, theoretical tools that Polanyi provides are extremely useful for elaborating what this strategy might look like. The three key tools are: democratization as an open ended process, synergy among multiple levels of contestation, and the concept of money as a fictitious commodity.

1. Democratization as an open ended process.

As noted earlier, one of the reasons for Polanyi’s objection to the Soviet model of central planning is that it disempowered trade unions, consumer cooperatives, and other bottom up organizations that he believes could and should play a central role in the management of the economy. As with other democratic theorists, Polanyi envisions a process of learning through which the people would become progressively more effective as a democratic force both in exerting influence over government and over key economic decisions. In Wright’s terms, he can be seen as an advocate of “deep democracy” that includes “robust egalitarian electoral democracy, “empowered participatory governance”, and the use of associational democracy as a governance mechanism.14

This increased capacity of people for self-governance is relevant to the transformation problem in much the same way that Gramsci envisioned the creation of a counter hegemonic alternative to the existing order.15 As the citizenry develops a deeper understanding of how the economy works and a greater role in managing it on a day-to-day basis, they are less likely to be

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14 Associational democracy refers to giving civil society organizations such as trade unions an active role in the governance of society. There is considerable overlap between Wright’s concept of deep democracy and the concept of “advanced democracy” used by Karl Klare, “Critical Perspectives on social and economic rights, democracy and separation of powers.” Pp. 3-22 in Helena Alviar Garcia, Karl Klare, and Lucy A. Williams, eds., Social and Economic Rights in Theory and Practice. New York: Routledge, 2015.

swayed by the standard ideological arguments made in defense of privileging employers and investors. They are more likely, for example, to continue to support a government that is facing increasing resistance to new regulatory or tax measures by business interests. Wright identifies the “transition trough”—the downturn in economic output that results from deliberate business and investor sabotage of a left-wing government-- as a principle obstacle to electoral paths to socialism. An expanded capacity for self-governance could mean greater ability to withstand the transition trough in two ways. First, democratically controlled firms could increase output to make the transition trough less severe. Second, democratic understanding could provide the populace with greater patience to endure the difficulties of the transition trough.

2. Synergies across multiple levels of contestation.

One of the greatest strengths of Polanyi’s analysis is that because of his focus on the gold standard, he puts the global nature of the market order at the heart of his analysis. In a sense, one can read The Great Transformation as an extended discourse on the difficulties of creating socialism in one country given the complex historical interdependence created by trade and capital flows. Polanyi is also acutely cognizant of how important capital strikes and capital flight have been historically as a tool by which business interests have been able to resist democratic pressures for reforms that were threatening to investors and firms. On the contrary, what he describes as the need to stabilize the exchange rate often serves as a justification for austerity policies that lower wages and increase unemployment.

But Polanyi avoids slipping into despair by recognizing that the global regime—the rules of the game governing international trade and finance—are themselves political structures. He emphasizes repeatedly the close linkages between England’s rise to global dominance and the
institutionalization of the gold standard system. He also shows how that same system collapsed when England no longer had the financial and military might to defend it. Most importantly, Polanyi correctly anticipates Bretton Woods when the world’s key nations came together to consciously construct a new international economic regime that did, for a time, place substantially fewer constraints on national policy makers than the gold standard regime.¹⁶

As Block and Somers argue, Polanyi envisions three distinct levels of political and economic contestation.¹⁷ There is a local level in which social groups fight for particular goals. There is a national level that very often conditions what could be won at the local level. And finally, there is a global level that, in turn, conditions what could be durably won at the national level. (Today, one would also have to include a fourth level, that of supra-national regional institutions, such as the European Community that exist between the national and the global levels.) Polanyi emphasizes that each of these levels had its own specific set of determinants, but there are historical moments in which strains or tensions at one level create opportunities at lower levels. He emphasizes, for example, that the Nazi seizure of power in Germany in 1933 was enormously facilitated by the crisis of the international gold standard that made it politically feasible for Hitler to abandon the gold standard and pursue a policy of national self-sufficiency.

In a series of papers, Peter Evans elaborates this synergistic framework to envision a counterhegemonic process of reformed globalization.¹⁸ The basic idea is that locally-based movements can band together to create more powerful national political forces that win reforms

¹⁶ With the shift to floating rates in 1973, much of the protective apparatus of the Bretton Woods order was incrementally dismantled, so that governments lost much of the policy autonomy that they had previously enjoyed.
that help those local movements to remain organized and effective. At the next step, some of these organized social movements, such as labor and environmental activists, begin to organize at the global level to give local and national organizations more leverage and to win further reforms. At the same time, reformist national governments begin to use their global clout to push for reform of the global order. The Brazilian case is exemplary. A series of intense local labor struggles in the 1970’s led to the creation of the Workers’ Party (PT) that, in turn, began to contest for power at local and national levels. With the election of its candidate, Lula da Silva, as President in 2002, Brazil began exerting its power within global organizations such as the International Monetary Fund, the World Bank, and the World Trade Organization to create more space for Brazil and other nations to follow a more social democratic path of development. Most recently, Brazil has played a key role in the BRICS alliance that includes Russia, India, China, and South Africa, who have agreed to create a new global development bank that would compete directly against Western-dominated development institutions.

To be sure, the process of reforming global institutions that Evans envisions is still in its very early stages. The existing global rules of the game for trade and finance continue to be heavily biased in favor of giant corporations and financial institutions based in the U.S. and Europe. But there are concrete examples of social movements winning victories by “shifting scales” and mobilizing resources at the global level. There are also cases where grassroots mobilization has prevented trade and investment agreements that would further undermine democratic institutions. Moreover, grassroots mobilization has placed the issue of a global transaction tax on the global agenda; the European Community has agreed in principle to implement such a tax.
Evans’ core point is that this process of incrementally reforming global governance institutions to expand democratic governance at the local and national level is feasible because of the dynamic that Wright identifies as “symbiosis”. 19 Symbiosis refers to openings to reform that occur through positive class compromises that simultaneously benefit subordinate classes and the economically powerful. Transnational businesses need effective global rules and global institutions or they simply would not be able to operate profitably and predictably in dozens of different nations. They are trying to avoid the nightmare situation where each nation is able to make up its own rules governing valid contracts, tariffs, intellectual property, and a host of other regulatory issues. 20 In order to get to greater global uniformity and predictability, they have reason to make concessions to social movement pressures. Moreover, since global financial firms have different interests than global petroleum firms and there are longstanding divisions between firms based in different nations, it is theoretically possible that those pushing for tighter regulation could use a “divide and rule” strategy to overcome business opposition on specific issues.

Such incremental reform victories raise the possibility of creating a global regime that would shift the balance of power in national political struggles against property interests. For example, the development of a better global regime to avoid tax evasion and disruptive flows of hot money might also significantly discourage the use of capital flight as a weapon that propertied interests use to weaken political support for governments that they perceive to be hostile to their interests. Increased political space at the national level might then create pressure for further reforms at the global level, and so on.

19 Wright, Envisioning.
20 To be sure, whatever set of rules are in place, individual firms will have incentives to subvert the rules by making private arrangements with particular governments. The complexity is that in the aggregate, businesses want to have a level playing field where such private deals are not allowed. This issue is currently being played out around Apple’s highly favorable tax dealings with Ireland.
In short, multi-level contestation provides a powerful alternative to the logic of encirclement in which progress towards socialism in one country is blocked by the hostility of other powers. Since processes of globalization are moving the world away from the hegemony of a single dominant power to governance by multinational and global institutions, it becomes conceivable that as those global institutions are reformed, they would tolerate or even support further democratic advances at the national level.

3. Money as a fictitious commodity.

Polanyi’s well known discussion of fictitious commodities is essentially an argument that market societies can never actually operate in the way that is claimed by the theory of market self-regulation. Since land, labor, and money are not actually produced for sale on the market, government always must play a role in managing the supply and demand for these critical economic inputs. This simple fact creates a vulnerability that those favoring socialism can utilize to force incremental change. Think of it this way. If true “laissez-faire” were actually feasible, governments could say “There is absolutely nothing we can do to influence the supply of money and credit.” But since governments had to create central banks to regulate the supply of money and credit, this option is not feasible. Governments are forced to the weaker position of saying, “The laws of economics require that the supply of money and credit be governed by technical rules that cannot be understood by those who have not become expert in the subject.” But given the periodic crises that occur in market societies that are often traceable to errors in the management of money and credit, this is a claim that can easily be challenged.

21 A number of analysts have suggested that knowledge can also be analyzed as a fictitious commodity since it is increasingly critical to the economy, but it is usually not produced to be sold on the market. This argument is obviously relevant to Polanyian socialism, but for reasons of space, will not be elaborated here.
Polanyi’s suggestion is that all three fictitious commodities present openings to a socialist politics in which managing their supply and demand is subject to democratic politics. We see this in efforts to regulate the labor market to reduce the power differential between employers and employees and in the introduction of land use regulations that assure that housing is affordable and that firms are forced to reduce environmentally destructive activities. But precisely because money and credit are the lifeblood of a market economy, subjecting them to democratic control presents a uniquely important strategic resource for those who are trying to transform society in a more egalitarian direction.

The democratic management of money and credit are of critical strategic importance for three separate reasons. First, one can think of differential access to credit as the principle axis of stratification in the current global economy. Literally everyone could be placed on a single scale that combines the amount they could borrow and the favorability of the terms. At the top would be the owners of the largest hedge funds who can borrow tens of billions to finance leveraged positions at low interest rates and with fairly lenient conditions, while at the bottom are the poor of the planet whose only possibility of borrowing would be small amounts at confiscatory rates. Moreover, both historically and in the present, one of the major levers that employers have relative to their employees is their easier access to credit. When employees walk out and try to start their own cooperative firm, they almost always fail because they cannot borrow the funds that they need. 22

Second, as already noted, access to credit is a powerful disciplinary mechanism for defending the inequalities and injustices of the existing order. This is most obvious in the case of capital flight that is designed to disrupt an administration that is seen as hostile to propertied

interests. But we see the same dynamic when borrowers face the need to refinance their loans. In the Eurocrisis, for example, we saw nations on the periphery of Europe suffer from the kind of discipline that was historically meted out to developing nations; they were forced to accept painful austerity in order to receive additional credits from the IMF and the European Community.  

Third, the high level of dependence of market economies on an effective system for governing the supply of money and credit creates an opening for a reform strategy that combines what Wright describes as symbiotic and interstitial modes of transformation. Symbiosis, as we have seen, refers to the possibility of positive class compromises because propertied interests also need a stable supply of money and credit. Interstitial strategies are those that take advantage of the complexity of existing market systems to build up institutions that strengthen democratic and egalitarian political forces. A strategy that combined symbiosis and interstitial element is one where movements would extract a series of class compromises that had the effect of incrementally eroding the political power of propertied interests.

In short, the project of democratizing the financial system—at both the national and the global level—could be the key to an effective strategy of Polanyian socialist transformation. To be sure, democratizing finance would have to be combined with multi-pronged efforts to deepen democracy, so that citizens have greater authority over both governments and the market. The elements of deepening democracy have been extensively discussed, so they can be quickly summarized here:

► Campaign finance reform to reduce the influence of properties interests on electoral outcomes.

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24 Wright, Envisioning.
Implementing voting reform that would facilitate high rates of participation in the electoral process.

Policies of social inclusion so that marginalized populations would have the opportunity to participate in the political process.

Expansion of popular sovereignty by eliminating requirements for supermajorities to pass certain types of legislation and subjecting central banks to the direction of elected legislatures.

Elimination of restrictions on popular sovereignty in international treaties such as the investor protection provisions included in NAFTA and other bilateral treaties.

Reforms that would give employees more rights and greater voice in the workplace.

Expansion of popular participation in local governance including new mechanisms to give citizens voice in infrastructure planning and regional development.

Greater reliance on associational democracy that empowers groups in civil society.

Moreover, without sustained efforts to respond to the threat of climate change, there will be no prospect of democracy whatsoever, so I am also assuming rapid progress in reducing carbon emissions.

However, assuming that progress was being made along each of these fronts to make society more democratic and more environmentally sustainable, the democratic transformation of the financial system is the strategically central element because it has the potential to deprive property holders of their key weapons for blocking progressive change. Moreover, as access to financing is democratized, people will be able to see that the wealthy are no longer indispensable to an effective economy. The efforts by the wealthy to hold on to power will be more simply seen as a simple exercise in self-interest—a drive to protect privileges that no longer have any moral or economic justification.
Part II: Cracks in the Structure

The democratization of finance has become a historical possibility precisely because the existing financial system in developed market economies has failed so completely. One part of that failure became acutely obvious with the Global Financial Crisis of 2008, but other dimensions of failure are equally important, even though they are less familiar. The working hypothesis is that these less well known failures will become increasingly visible in the years to come, and there will be demands from all parts of the political spectrum for financial reform. It is in this context that the project of democratizing finance will become increasingly feasible as a political project. The argument here focuses on five main failures or cracks in the existing financial system.

This part of the analysis is focused on the financial system in the United States, but it has important implications for the rest of the world since U.S.-based financial institutions and corporations exert pervasive power on a global basis. Moreover, the U.S. model of a highly financialized economy has been extraordinarily influential internationally and has inspired reforms in other nations intended to make their systems more similar to the U.S. model. Hence, many of the weaknesses of the U.S. financial system are present to a greater or lesser degree elsewhere in the world. So the argument here is that a project that begins with the democratization of finance in the U.S. would open up political space in other nations and it could also inspire the kind of parallel initiatives in other nations that are a precondition for needed reforms at the global level.
1. The Too Big to Fail Problem.

It is now widely recognized that successive U.S. governments beginning under Reagan created a nightmare by encouraging greater and greater concentration in the banking industry. 26 Historically, popular distrust of concentrated financial power on Wall Street had produced a variegated and highly competitive banking industry. For example, up until the late 1970’s, there were practically no banks that had branches in more than one state and consumer deposits were spread out across commercial banks, Savings & Loans, mutual banks, credit unions, and small local banks.

Policymakers in Washington worried that this banking structure was highly inefficient and that it would make it difficult for U.S. financial institutions to compete effectively in the global market against the largest Japanese and European banks. They launched a variety of initiatives designed to produce consolidation in the banking industry, so that giant U.S. banks would be able to compete effectively in the international arena. These initiatives are often spoken of as “financial deregulation”, but this is inaccurate since an elaborate regulatory structure remained in place and government officials were intimately involved in the resulting concentration of the banking industry. Most importantly, the giant financial institutions that emerged out of this set of policies understood that they would be bailed out by the government whenever such a rescue was needed. 27

This reality of “Too Big to Fail” (TBTF) worked to exacerbate the logic of financial instability that was initially identified by Hyman Minsky. 28 Minsky recognizes that for-profit

banks are always tempted to increase their level of profitability by increasing the riskiness of their balance sheets. Such increased risk could come either from greater leverage or holding riskier assets or a combination of the two. And competition among banks would intensify the temptation since those following riskier strategies would likely be showing higher rates of return.

Minsky sees only two factors that could dampen this drive towards greater risk. First, worries that higher risk might get the bank into trouble could attenuate the drive for higher profits. But once the large institutions were designated as TBTF, this support for caution disappeared. Second, Minsky emphasizes the critical role that bank regulators need to play in pushing back against the drive to take on greater risk. But as we know, the Federal Reserve and other bank regulators simply did not understand the Minsky dynamic; under the considerable influence of Fed Chairman Alan Greenspan, they assumed that the self-interest of bankers would be sufficient to contain their appetite for risk. 29 In fact, as part of the strategy of supporting ever greater concentration of the financial sector, regulators continually approved requests to increase the amount of leverage that financial institutions were permitted to employ.

The consequences of this error are too well known to repeat here. Suffice it to say that the total cost in global output that was lost because of the 2008 Global Financial Crisis has caused some analysts to describe it as the Greater Depression. 30 In the aftermath of the crisis, the U.S. Congress passed the Dodd-Frank legislation which was supposed to end Too Big to Fail. However, a series of knowledgeable analysts (have noted that concentration in the U.S. banking

29 Greenspan famously said in Congressional testimony: “I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms....” Edmund Andrews, “Greenspan Concedes Error on Regulation.” New York Times, October 24, 2008, B1.

sector has become even greater in the years since the crisis and that the Dodd-Frank framework is unlikely to prevent another episode in which giant banks take on too much risk. 31

The crux of the problem is the difficulty of durably regulating financial institutions that are able to generate huge flows of profits. By recycling even a relatively small share of these profits into campaign contributions and hiring armies of lawyers and lobbyists, these institutions have shown a remarkable ability to either bribe or intimidate regulators so as to preserve their freedom to take on excessive levels of risk. And as long as these institutions are so large, the government is extremely unlikely to let them fail. The worst case scenario for the top managers is that in the next crisis, they would simply be replaced by other experienced executives from within the financial community.

2. The Failure of Corporate Governance.

It is standard practice to treat problems of financial firms as completely separate from the problems of nonfinancial corporations. But this is a mistake for several reasons. How large corporations are governed is itself a product of financial arrangements such as the degree to which business firms rely on stock issues, bonds, or bank debt for financing. Moreover, the governance of large corporations in the U.S. has become increasingly financialized over the last generation. 32 Top managers look at their firms as bundles of assets and they think of their role as how to maximize the yield on those assets. Finally, any conception of democratizing finance also has to mean subjecting large corporations to higher levels of democratic control.


But the governance structure of corporations in the U.S. is marked by deep flaws. The ideology of “shareholder value” was initially proposed as a solution to the problems created by the separation of ownership and control—the fact that those who ran the firm on a daily basis have different interests from the shareholders. The proposed solution was to use the incentive of stock ownership to align the interests of corporate managers with shareholders. If managers focus like a laser on maximizing shareholder value, they would then steer the firm in the best possible direction producing a win for both owners and managers.

Over the last generation, the compensation of top corporate managers has shifted towards stock options and stock grants just as the theorists proposed. But the result has not been to solve the problems created by the separation of ownership and control but to exacerbate them. Essentially, top managers have used the ideology of shareholder value to justify driving their compensation levels through the roof. The share of corporate profits that now flow to top managers rather than shareholders has reached record levels. Moreover, there is little indication that the actual performance of firms has improved; extremely high levels of executive compensation characterize both well-performing and poorly-performing firms. And in fact, differentiating between the two is difficult. We learned from the extreme cases of ENRON and WorldCom that there is considerable opportunity in the techniques of corporate accounting to make an unprofitable firm appear to be profitable.

Moreover, as Lazonick has documented in a series of publications, the central instrument of this new system of executive compensation is a practice that was historically considered illegal—share repurchases. Corporate executives have persuaded regulators that returning money to the shareholders by using corporate funds to purchase shares is a legitimate business

activity. But a well-timed announcement of a share buyback program is a wonderful way to
drive the firms share prices higher even if this quarter’s results appear somewhat problematic.
And, of course, if those same executives time the share repurchases to synchronize with the
timing of their own stock options, they can maximize the improvement in their own portfolios.

In recent years, this highly problematic set of practices has intensified with firms
borrowing billions of dollars by floating bonds that are then used to finance share repurchases.
With interest rates at historically low levels, this appears to be a harmless way to make the stock
price rise continuously while sustaining excessive executive compensation, but it comes at the
expense of the firm’s long term stability. Unproductive borrowing during an economic
expansion increases the risk that borrowing terms will deteriorate dramatically when revenues
subside in the next economic downturn.

The systematic manipulation of share prices through buybacks is the most extreme
expression of the short-term time horizon problem that is built into the current system of
corporate governance. For top managers, both their hold on their offices and their excessive
levels of compensation are tied to the quarterly reports of the firm’s earnings. When these fall
short of Wall Street’s expectations, there can be a troublesome slide in the share price. So
almost all executive energy is devoted to managing earnings and the per share returns which can
be improved by timely buybacks. But the consequence is that those categories of expenditures
whose benefits will come three to ten years in the future are systematically reduced. This is the
context in which many large firms have reduced their expenditures on research and development,
opting instead for “open innovation”. The term means that innovations are something else to be
outsourced; they will be obtained through acquisitions and licensing rather than through the
firm’s own efforts. This has also been the logic that has led U.S. firms to shift a large share of
their manufacturing operation to cheaper labor sites overseas. But academic research has clearly shown that those firms that have been most successful in global competition are those that co-locate production and research and development. 34

In short, the performance of large corporations in the U.S. has declined across the same period in which the compensation of top executives has soared. This is ultimately a question of finance because the system of corporate governance is based on the idea that each share of stock that is issued gives the owner a voice in the management of the firm. Whatever the theoretical justification for this system of shareholder democracy, it is not working as intended. On the contrary, it has degenerated into a system by which executives have been able to command an ever larger share of corporate profits for themselves.


The obvious question is if both banks and nonfinancial corporations are so poorly managed, why funds continue to flow from households into bank deposits and the purchase of corporate equities. The basic answer is a combination of inertia and the institutionalization of a system for directing household saving into certain channels. In the case of consumer bank deposits, what happened is that waves of mergers created a small handful of giant mega-banks. Most households didn’t make an affirmative decision to bank with Citi Bank or Bank of America; it just happened that after all of the acquisitions of other banks, that is where their deposits ended up. And these giant banks invested in very expensive advertising campaigns that were designed to make these impersonal institutions appear to be warm and fuzzy. The goal was to reinforce inertia and discourage consumers from going through the paperwork of moving their money to smaller banking institutions.

In the case of corporate stocks, the mechanisms are somewhat more coercive. For one thing, a good deal of household saving takes the form of pensions, insurance policies, and supplemental retirement plans such as the 401K. The actual investment of the money is done by pension funds, insurance companies, and mutual funds that are legally constrained in the types of assets that they are allowed to acquire. They invest primarily in the stocks of the corporations whose shares are traded on the major stock exchanges—the New York Stock Exchange and the Nasdaq. In 2013, just 1,000 corporations in the U.S. account for close to 90% of the value of all corporate equities and it is almost entirely shares of these 1,000 firms that are held by these large institutional investors.

But middle class and upper middle class families also have substantial saving that they directly control. But, however, their options are limited. They can purchase government or corporate bonds, but most studies have shown that the long term yield of such instruments is lower than that of corporate equities. They can invest in real estate or search out small and medium-sized businesses that are looking for investors, but these activities tend to be both time-intensive and risky. Consequently, most end up putting their funds in mutual funds that own shares in the same 1,000 companies that are held by the other institutional investors.

This channeling of funds in one direction is a serious problem for two reasons. First, the largest corporations are responsible for an ever diminishing share of employment in the United States and this is a pattern that is likely to continue. These firms have been most aggressive in using technology and low paid foreign workers rather than domestic employees. As a consequence, employment at large firms is no longer the key motor of economic development

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36 Gerald Davis, “After the Corporation.” *Politics & Society* 41:2 (June 2013):283-308
that it was in earlier decades. Communities can no longer rely on the strategy of attracting big firms as their main way to assure adequate employment opportunities.

Second, these 1,000 corporations do not depend on these flows to finance actual investment. In the aggregate, the corporate sector in the U.S. has been for a generation returning funds to the household. This happens because the retirement of shares through acquisitions and buybacks greatly exceeds the volume of new public offerings each year. Most of the large corporations finance their new investments with retained profits and only a very small number of new firms join the ranks of the blessed 1,000 each year.

The reason for the limited number of new Initial Public Offerings each year has to do with the gatekeeping role of the investment banking houses that underwrite new stock offerings for firms that are to be listed on the major exchanges. These firms generally prefer a small number of highly profitable deals over many deals with limited profits.37 So under normal circumstances, it is only rapidly growing firms with unusually strong growth potential that are allowed to raise money through IPO’s. The consequences it that thousands of other medium sized firms are extremely limited in their ability to raise capital because their shares are listed only on the lower status stock markets. But for the investment banking houses, this system works because it maintains strong demand for the shares of the blessed one thousand who continue to be major users of investment banking services, especially in the lucrative area of mergers and acquisitions.

And, of course, this routing of a large share of household saving into holding already-issued shares of major corporations is what gives corporate executives the freedom to enrich themselves and continue to pursue short term profits. If new attractive channels for household

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37 There was an exception during the internet bubble at the end of the 1990’s when many not-yet-profitable internet firms were taken through the IPO process because of virtually unlimited investor enthusiasm.
saving were to become available, this incestuous system that unites the interests of institutional investors, investment banks, and top corporate executives would be threatened.

4. Deepening Inequality.

There is little doubt that the financialization of the U.S. economy that has occurred over the last generation is closely connected to the dramatic increases in economic inequality that have been so carefully documented by Thomas Piketty and his colleagues. 38 Many of those in the top tenth of 1% with the largest income and wealth gains are either working in the financial sector or corporate top executives who have benefited from stock options. But the growth of the financial sector has also created new mechanisms by which those with wealth are able to protect their assets from taxation. A whole industry now exists that makes it extremely difficult for the government to raise revenues from the ultra-rich who have made increasing use of off-shore tax havens and extremely complex structures of trusts and shell corporations. 39

Moreover, the wealthy and corporations have successfully lobbied for “tax reforms” over the last thirty-five years that have significantly eroded the yield from federal taxation of both corporate and personal income. The result has been an ongoing fiscal crisis that envelopes every level of government and has produced systematic cutbacks in the services that are available to working and middle class people. One symptom of these cutbacks has been dramatic increases in the cost of public higher education that has been partially mitigated by imposing a growing debt burden on many young people.

Moreover, the combination of stagnant income for the 99% and an ongoing fiscal crisis has intensified the longstanding inequalities that have plagued U.S. society. Minority communities have been particularly hard hit by stagnant incomes and government retrenchment. But the negative impact on white working class and lower middle class communities has also been dramatic. Since these communities have also been hard hit by the contraction of unionized factory employment, the practical realities of financialization have blocked any effective government initiatives to address their needs either in the short term or the long term.40

5. Systematic underinvestment.

While the current system channels funds into the stock market to firms that are accumulating vast amounts of cash, there are critical types of domestic investments that are not currently being financed at sufficient levels:

A. There are clean energy and conservation retrofits for both residential and nonresidential buildings that have been proven to pay for themselves in a relatively short period of time. These include replacing older fixtures and appliances, installing insulation and reflective roofs, and accelerating the introduction of new energy-saving building technologies. These are expenditures that produce higher annual returns at lower risk than most other types of investments. But to date, our financial system has been reluctant to extend credit for these projects to homeowners, businesses, or public entities.

B. There are many small high-tech firms that are pursuing the commercialization of new technologies. Many of them perish as they cross the “valley of death” – the period between a

40 And, of course, both minority and majority homeowners experienced unprecedented disruptions because of the foreclosure crisis that followed from the 2008 global financial crisis. See Kurtulus Gemici, “Beyond the Minsky and Polanyi Moments: An Alltimate Account of the Foreclosure Crisis.” Politics & Society, forthcoming.
laboratory breakthrough and having a commercial product.\textsuperscript{41} Even if they survive in the short term, the incentives are very strong to sell the firm to a larger corporation rather than remaining independent. But often after takeovers the new owners might abandon the innovative technology for a variety of different reasons.

C. There is a more general problem of financing for the larger universe of small and medium sized businesses that are not high tech innovators. These firms loom ever larger in the U.S. economy as the largest corporations have reduced domestic employment and become reliant on these smaller firms to produce many of their key inputs. Data from the Federal Reserve show that even as nonfinancial, noncorporate businesses were significantly expanding their levels of investment during the 2000’s, they were able to rely on outside capital to finance only a small share of their investments.\textsuperscript{42}

D. There are also many infrastructure projects—including rebuilding of decaying bridges, sewer systems, and water treatment plants—that have been deferred because of the difficulty that local and state governments face in raising the needed capital.\textsuperscript{43} In fact, in 2009, the American Society of Civil Engineers estimated the total cost of rebuilding the national infrastructure to be $2.2 trillion with the nation falling further behind each year. This does not even count the costs of shifting an energy system dependent on burning carbon-based fuels to renewable energy.

\textsuperscript{42} Federal Reserve, \textit{Flow of Funds Accounts}, Table F103.
sources or improving mass transit and inter-city transportation to reduce the wasteful dependence on the automobile.

E. The deepening economic inequality in the United States has meant that many households in the bottom half of the income distribution are effectively excluded from any kind of non-predatory access to credit. As Jacob Hacker has shown, household income for many is highly unstable with dramatic ups and downs being common as a result of spells of unemployment or health crises or marital instability that are not offset by government transfer payments. But the consequence of this instability of household income is to produce extremely low scores on measures of creditworthiness.

This lack of access to credit on reasonable terms makes it far harder for households to engage in any of the kind of “bootstrap” operations that have historically been routes to upward mobility. For example, small scale entrepreneurialism such as fixing up decaying housing becomes impossible without some source of credit.

Aggregated together, these five areas of systematic underinvestment represent an enormous problem for the U.S. economy both in the short term and the long term. In the short term, levels of new productive investment are being unnecessarily reduced which, in turn, means slower growth of economic output and slower growth of employment. Over the longer term, the failure to invest in small innovative firms and in critical types of infrastructure will likely place additional barriers to future economic growth. At the same time, these problems of misallocation also suggest the possibility of creating a broad political coalition to carry out a

major structural reform of the nation’s financial system. This coalition could bring together organized labor, environmentalists, minority communities, small business, and proponents of local economic development.

**Part III: Design Principles**

These serious cracks or deep flaws in the current financial infrastructure help us to see how the democratization of finance could become a unifying political program that could advance the long-term goal of subordinating the market to democratic politics. But the next logical step is to spell out the design principles that would undergird a deep reform of the financial infrastructure. As we have seen from the post-2008 debates, when the main issue on the table is avoiding another disastrous financial crisis, the results are relatively minor reforms that might simply be cosmetic. But a positive vision of how the financial infrastructure should operate could undergird a more serious reform effort.

Polanyi’s analysis of money as a fictitious commodity is a useful starting point here. It follows for Polanyi that the conventional accounts of how a market system works are based on a falsehood because everyone has to pretend that these fictitious commodities behave in the same way as standard commodities. But this dishonesty is particularly acute when it comes to the supply of money and credit. On the one side, most defenders of “free market” arrangements acknowledge the need for a governmental institution—the central bank—whose role is to influence the supply of money and credit to avoid both inflation and deflation. Moreover, they also recognize that the central bank must play the role of lender of last resort because financial intermediaries are vulnerable to runs even when their assets well exceed their liabilities.
And yet, most of these same people go on to argue that the market for credit is basically a self-regulating system which will achieve optimal results when managers of financial intermediaries are allowed to respond to the signals of the competitive marketplace. They also argue that for the same reasons financial regulators should not be heavy handed but should grant these institutions considerable latitude. Moreover, they also insist that governments—at all levels—must avoid deficit financing, except under very special circumstances. They insist on balanced budgets because government spending is not subject to the same kind of market discipline that pushes private actors to economize on the use of resources.

*The Role of Government*

All of these claims are deeply problematic. In the real world of actually existing market societies, government and financial intermediaries have long been deeply intertwined and interdependent. And, in fact, the developed societies did not reach their current level of development by pursuing a laissez-faire approach to the financial sector. In fact, in the United States, some of the central parts of the current credit market emerged only when government stepped in and offered various kinds of incentives or guarantees to private borrowers. For example, the rise of the thirty year residential mortgage in the United States was closely tied to mortgage guarantees offered by the VA and the FHA. Similarly, the Small Business Administration has underwritten a significant share of business lending to small firms through its loan guarantees. Moreover, government guarantees have also figured prominently in the rapid growth of educational loans to students.

Other developed market societies have also used combinations of guarantee schemes, tax incentives, and public sector banks to assure that capital flowed in particular directions. In
Germany, for example, what were historically state-owned Landesbanks played a critical role in providing credit to the German Mittelstand—the medium sized firms that continue to be central to the German manufacturing economy.  

But the other side of the story is the considerable evidence that profit-oriented financial intermediaries are dangerous. We have already noted that when financial intermediaries are not effectively restrained by regulators, they will take on higher levels of risk in order to realize higher profits. As indicated by repeated instances where banks help fuel asset price bubbles by increasing the allocation of credit, there is no justification for attributing a higher level of rationality to profit-oriented financial institutions. If it were not for periodic bailouts organized by governments, such entities might well have disappeared completely.

All of this suggests that government can and should play a central role in structuring the financial system to achieve sustainable long term economic growth. And in contrast to the current system which centralizes power in mega-firms and directs capital into a few narrow channels, an ideal system would be more decentralized and create more diverse channels for capital investment.

It also follows that direct government spending has an extremely important role to play in allocating capital to productive uses. Some types of spending, including support for scientific research, public education, and a variety of forms of infrastructure are pure public goods where government is the only appropriate funder. But there are also many mixed cases where private parties gain income streams but the streams might not be sufficiently large or sufficiently predictable to justify the initial investment. It is here that government can and should subsidize the investment through interest rate subsidies or loan guarantees or tax benefits.

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There are many areas where government interest rate subsidies represent an important policy tool. In the U.S., the tax free status of municipal bonds is one such subsidy that substantially strengthens the access of local government entities to the capital market. However, more direct subsidies in the form of loans at below market rates have also been widely used in support of housing, agriculture, small business, revitalization of low income communities, infrastructure projects, clean energy and student loans.  

There is considerable room for expanding such programs and for increasing the size of the subsidy for those activities that meet important social goals.

Moreover, these necessary forms of government spending either to produce public goods or to help subsidize their production are inevitably rising as a percentage of GDP. Outlays for education, health care, and scientific research are all subject to Baumol’s cost disease because of the difficulty of realizing ongoing productivity gains.  

Moreover, developed societies have need for an ever-growing supply of infrastructure, and a significant share of these projects—bridges, tunnels, airports, water treatment plants—are not amenable to mass production techniques.

This means that arbitrary limits on government spending such as requirements that outlays must balance with income in a given year or the Maastricht Treaty rule that total government debt must not exceed 60% of GDP are economically irrational. Greater outlays by government are often needed as a critical catalyst for economic growth, and there is no persuasive justification for denying government entities the opportunity to use debt to finance productive investments.

48 William Baumol, The Cost Disease. New Haven: Yale University Press, 2012. Baumol’s point is that a string quarter will always require four members, so the cost of the concert ticket will inevitably rise relative to products that are produced with diminishing labor inputs.
These arguments suggest two important principles for democratizing the financial system:

1. *There should not be arbitrary restrictions*—such as balanced budgets or the Maastricht rule limiting government debt to 60% of GDP—to limit government borrowing for productive purposes. Those forms of investment that produce pure public goods such as funding for scientific research, certain types of infrastructure, and public education should be carried out by government.

2. Government has an active role to play in allocating credit to finance productive economic activity, and it should use a full range of policy tools including interest rate subsidies, loan guarantee programs, and tax incentives to assure that capital flows in the most productive directions.

*The Organization of Corporate Governance*

The earlier discussion points to two central problems in the U.S. system of corporate governance. First, in the large corporations, executives have too much power and have been able to command a disproportionate share of corporate profits for their personal compensation. This is particularly irrational in an era where corporate profitability increasingly depends upon the exercise of collective intelligence by a labor force that includes layers of highly skilled employees. Second, small and medium-sized firms are often starved for capital and see few opportunities to continue as independent firms. The mechanisms for channeling capital towards the biggest firms reinforce the dynamic where the best option for independent entrepreneurs is to sell their firms to large corporations that have deliberately outsourced innovation. However, this
is an irrational outcome because medium-sized firms can be the optimal instrument for
continuously innovating at the global frontier.\textsuperscript{49}

Blasi and his co-authors have shown that many of the large firms have sought to handle
this first problem through schemes that recognize employees as stakeholders in the firm.\textsuperscript{50} A
surprisingly high number of the largest firms use various kinds of employee stock ownership
plans to persuade employees that they have a significant ownership stake in the firm. However,
very few of these schemes provide employees with any effective voice in corporate decision
making and this leaves top managers free to pursue short-term strategies and expand their share
of corporate revenues.

A better way to recognize employees as stakeholders is to give them a voice in the firm’s
management.\textsuperscript{51} This is an important step in democratizing the economy because it would assure
that more diverse interests were represented in key corporate decisions. But giving employee
voice is also the best strategy for improving corporate governance. Employees collectively have
an interest in the long-term survival of the firm, so they can be expected to push back against
managerial short-termism. Most importantly, the key reason that corporate boards are generally
ineffective is that top management controls the flow of information to outside board members.
By including employee representatives in these highest level deliberations, top executives would
have a much diminished ability to control the flow of information to the corporate board.

We have empirical evidence from Germany that the mechanisms that provide employee
voice in large corporations have improved the quality of corporate decision making while also
keeping a lid on executive compensation. Germany combines co-determination where employee

\textsuperscript{49} Berger, \textit{Making}.


representatives sit on corporate governing boards with strong unions and a system of works councils at workplaces. In combination, these mechanisms of employee voice have helped German corporations become world leaders in manufacturing sophisticated technological products.

But Germany also boasts a large number of small and medium-sized firms that are family-owned and that have proven to be highly successful in global competition. These Mittelstand firms generally provide for employee voice through cooperative labor relations with unions. But the key to the success of the German Mittelstand has been the availability of long-term financing from banks that has made it possible for these firms to remain independent and flourish. This suggests two additional principles:

3. **It is important to create a mechanism that would increase the role of employees in corporate governance.**

4. **The financial system should provide small and medium sized enterprises with a source of credit that allows them to remain independent and not pursue the route of public shareholding.**

*The Problem of Creditworthiness*

Financial markets are organized around gatekeepers whose job is to decide who is worthy of credit at what interest rate and with what conditions. While much is made in the literature about the distinction between national financial systems that center on bank lending and those that center on stock markets, the reality is that gatekeepers necessarily play an indispensable role in both systems. In bank-centered systems, lending officers at banks evaluate potential borrowers and establish the lending terms. In the U.S. system, investment bankers underwrite stock and bond issues by businesses, state and local governments, and other entities. While

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52 Deeg, *Finance Capital.*
impersonal markets determine the day-to-day value of the securities that have been issued, the investment banks play the role of gatekeepers. They are the ones who decide what entities are worthy of having their paper sold in a particular market and they shape the specific terms under which it is to be sold.

There is no way to avoid this gatekeeping function in the organization of capital markets. For the foreseeable future, there will be less available capital than potential projects that are asking for finance. Somebody has to make decisions about which projects are worthy and which are not and what are the relative levels of risk of different undertakings. And it is simply a fantasy to imagine that the gatekeeping can be done effectively by some version of voting on the internet or by judgments on an impersonal market. Effective gatekeepers are in a position to extract detailed disclosures from those raising capital that market participants are not eager to reveal more broadly. Without these disclosures, impersonal markets have no protection against fraudulent operations.

But if a financial system needs gatekeepers, everything hangs on the decision rules that those gatekeepers employ to evaluate creditworthiness. In the past, gatekeeping positions in the U.S. were filled largely with upper class individuals who had gone to the right schools and knew all the right people. It was simply commonsense for these gatekeepers to define creditworthiness in class terms; the closer an individual came to the manners and styles of upper class men, the more creditworthy they were seen to be. If they were female, from a minority group, or working class in origin, then they were obviously less creditworthy.

Potential entrepreneurs from disfavored groups were then forced to find other ways to borrow the capital they needed. Certain ethnic groups developed parallel financial institutions or

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used informal mechanisms such as rotating credit associations to finance business efforts. In the worst case, they might resort to desperate exchanges with predatory lenders whose terms would significantly reduce the probability of business success.

But the central point is that creditworthiness has been defined in ways that incorporated existing social hierarchies of class, gender, and race. The merits of a particular borrower’s project was much less important than who they were. During the course of the 20th Century, these definitions of creditworthiness came under sharp attack. Laws were passed that required that creditworthiness be measured in ways that were independent of these ascribed social characteristics. But not surprisingly, these seemingly objective criteria to evaluate creditworthiness still reproduce and recreate older inequalities.

This was particularly clear in the sub-prime mortgage crisis. A seemingly objective scheme was used to measure creditworthiness and people whose scores fell below a certain point were put into the sub-prime category where they were only eligible for mortgages with higher interest rates and more demanding conditions. While this scheme was allegedly color blind, minority households were disproportionately placed into the sub-prime category because on average they have substantially fewer assets than comparable white households. 54

A second problem with established ideas of creditworthiness is that they are excessively individualistic; they rest on the erroneous assumption that each individual entrepreneur either does or does not have the capacity to succeed. But the reality is that economic development is a collective project; whether one is talking about community revitalization or regional economic

growth, the process depends on interdependent decisions by multiple actors. Gatekeepers who understand this interdependence can tilt the playing field towards more successful outcomes.

In short, a system of democratized finance would involve the continuing effort to improve the criteria used by gatekeepers to evaluate the creditworthiness of different parties attempting to raise capital. Such a system would need to incorporate four additional principles:

5. Evaluation of creditworthiness of individuals and organizations should be based on an historical analysis that takes into account the obstacles that the individual or firm overcame to get to this point. Using this kind of historical analysis will operate against the credit system simply reinforcing the existing distribution of income and wealth.

6. Evaluations of creditworthiness should no longer privilege profit-making firms. There is now sufficient data to show that alternative types of organizations, including employee-owned firms, can survive and flourish. It follows that there need to be new types of financial instruments to provide credit to these nontraditional firms.

7. The provision of credit should be done on a highly decentralized basis so that financial intermediaries can recognize the positive synergies that come from multiple investments in the same locality. Even if the food at a restaurant in a decaying downtown neighborhood is excellent, the business is much more likely to prosper if other storefronts on the same block are also being upgraded by entrepreneurs with access to credit.

8. There is a need for some portion of credit allocation to be done on a probabilistic basis to support firms that face high risks but have the potential for high rewards. This has been a critical mechanism in successful industrial districts where people move back and forth between being entrepreneurs and being employees,\textsuperscript{56} and it is the design principle of venture capital firms that operate on the expectation that most of the firms that they support will fail.\textsuperscript{57}

Organizing Financial Intermediaries

The problem with gatekeeping is that it is a labor intensive activity. Face-to-face work is usually needed to extract from borrowers the disclosures that are necessary to evaluate their creditworthiness. And it is here that profit-making financial intermediaries run into problems. Hiring loan officers is expensive and the number of transactions that each loan officer can handle in a given day or week is limited. When banks compare the profits to be generated by these loan officers with the profits generated by portfolio managers who buy and sell various securities, the portfolio managers almost always win.

For-profit banks have addressed this problem through automation. They have eliminated the high staffing costs of various forms of lending by using computer programs to score and evaluate loan applications. But these techniques tend to redefine creditworthiness as resemblance to a statistical norm. If the applicant looks similar to people who have paid off loans in the past, then he or she will receive credit on reasonable terms. If not, they will be denied credit or as with subprime mortgage lending, be required to pay a substantially higher interest rate than with other borrowers.


This kind of automation is a particular problem with small business lending. Since failure rates of small business loans are high, the computerized algorithms tend to limit credit to firms that have already proven themselves or to firms that have collateral in the form of real property. This tends to bias credit availability towards real estate development and away from other endeavors. 58

The best way to overcome this dynamic is to introduce significant competition from financial intermediaries who are not seeking to generate profits. These could take the form of credit unions, community banks, nonprofit loan funds, or banks that are owned by government entities, but the key is that their mission is defined as facilitating economic development in a particular geographical area. With this mission, they have a reason to employ loan officers who develop the skill set needed to provide credit to individuals and firms who fall outside the parameters of the standard lending algorithms.

Such institutions are far more likely to employ criteria of creditworthiness that emphasize the particular history of an individual or firm. With appropriate support from government, they would also be in a position to engage in synergistic lending by extending credit to multiple firms in the same area.

Moreover, when there is strong competition from nonprofit banks, there can be a shift in the strategies used by profit-oriented banks. When most financial intermediaries are ignoring the needs of small business, there is no real cost to following this trend. But if your nonprofit competitors are helping small firms develop into effective firms, you are likely never to regain them as clients since they will probably remain loyal to the bank that gave them critical support

at the beginning. In short, competition can force for-profit banks to invest again in skilled loan officers.⁵⁹

A second important reason to develop a significant nonprofit financial sector is to reduce the Minskyan danger that financial intermediaries will follow the path of pursuing higher risks by accumulating ever riskier investments. Here again, competition from more sober institutions might also operate as a restraint on profit-oriented firms since they would have an alternative place to deposit their savings. To be sure, cooperative or nonprofit status does not automatically solve this problem; unscrupulous managers can still pursue risky strategies while also bidding up their compensation rates. A strong regulatory apparatus is still needed to make sure that these institutions do not take excessive risks.

Finally, there should also be relatively low barriers to entry to create new nonprofit financial institutions as a way to counteract the tendency of existing institutions to become insular and unresponsive to newcomers or different constituencies. Even without an orientation to profit, there is still a need for ongoing competition among these institutions for consumer deposits and for loan applications.

This argument suggests two additional principles of a democratic credit system:

9. Government should facilitate the growth of nonprofit financial intermediaries because these institutions are less likely to engage in risky speculation and they are more likely to hire and retain the skilled loan officers needed to facilitate local economic development. This also means having mechanisms that encourage the creation of new institutions to respond to changing needs.

⁵⁹ This is consistent with the account of Germany in Deeg, Finance Capital.
10. **Government also needs to establish loan guarantee programs that help these nonprofit financial intermediaries engage in certain riskier forms of lending that promise high returns for local communities.**

**Part IV: Alternative Financial Institutions**

The strategy of financial reform proposed here has four main components. The first and most critical is to create a much larger sector of nonprofit retail financial intermediaries. These would be the base of a democratized financial system. The second piece would be to create a set of nonprofit institutions that would compete directly with investment banks to underwrite securities. The third piece is an incremental reform in corporate governance that would allow firms with employee voice to compete directly against those organized in the standard way. The fourth piece consists of global-level reforms that would complement the domestic reform project.

**New Retail Financial Intermediaries**

There are numerous models for nonprofit financial institutions that collect deposits from a geographical area and then re lend the funds for mortgages and to finance local business activity. Schneiberg describes how mutual banks were created in the pre-New Deal period as part of an infrastructure of local bottom-up institutions that played an important economic role particularly in the upper Midwest. 60 Deeg describes the important role that public and cooperative banks have played in financing economic activity in Germany, especially

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investments by small and medium-sized enterprises, over recent decades. \textsuperscript{61} Mendell and her co-author describe the complex web of locally-based financial institutions that have supported the development of the social economy in Quebec starting around 1996.\textsuperscript{62} Mazzucato and Penna document the increasingly central role that state investment banks are playing in countries such as Germany and Brazil.\textsuperscript{63}

The main emphasis here is on credit unions because they already have a significant presence within the U.S. financial marketplace. Credit unions are nonprofit financial institutions organized as cooperatives with each member having one vote and the opportunity to elect the organization’s leadership. As a consequence of the historic popular distrust of Wall Street in the U.S., much of the regulatory and support structure for credit unions to play an expanded role already exists. The U.S. government has a dedicated system of deposit insurance and regulation for credit unions and credit unions are eligible to be part of the Federal Home Loan Bank system that provides small banks with credit lines to help them through temporary liquidity crises. Furthermore, credit unions have accumulated a strong track record of functioning well even in economic downturns.

However, it also must be recognized that on the whole, credit unions in the U.S. have not been particularly dynamic or innovative in recent decades. Part of the issue is that existing legislation tightly restricts small business lending by credit unions. But even credit unions that were originally created through social movement energies tend to become routinized and limited in their focus as they age. Finally, until the process of computerization had progressed quite far,

\textsuperscript{61} Deeg, \textit{Finance Capital}.
credit unions simply could not compete with commercial banks in the range of services they provided.

Now, however, even very small institutions of this type—organized in networks—are able to provide clients with a broad range of financial services. For example, credit unions can provide access to a network of automatic teller machines and the ability to wire funds to other destinations. And these small institutions need not hire all of the staff required to do the appropriate due diligence for small business lending. This could be done on a contract basis with small, nonprofit consultancies that develop expertise in particular business domains and work with a range of different financial intermediaries.

Hence, with only two steps, it might be possible to set off a wave of entrepreneurial effort that would create new nonprofit financial intermediaries and reinvigorate those that already exist:

1. A federal matching funds program to help capitalize or recapitalize new or existing nonprofit financial intermediaries.

   Given the enormous costs that the society has paid for its dysfunctional financial system, an outlay of $50 billion over five years would be a small price to pay to create a vigorous locally oriented financial system. The idea is that local investors would raise $10 million to capitalize a new credit union or nonprofit bank and the government would provide an additional $10 million—perhaps in the form of a low interest, thirty year loan. Or similarly, a sleepy bank or credit union would be recapitalized with an additional $20 million that would be matched by $20 million from the federal government. The idea is that the matching funds would simultaneously signal the government’s strong support for these new institutions and create strong incentives for grassroots efforts to build this new sector.

2. A new system of loan guarantees to support lending by these institutions.
Along with the capital infusion, the federal government could also immediately provide loan guarantees for these institutions to lend to households, businesses, and government agencies for conservation or clean energy projects. The value of these investments has been well documented. Again, the urgency of a green transition would justify the relatively small budgetary commitment that would be involved since these loans for energy-saving should have a very small failure rate. But this would be an efficient means to underwrite a dramatic initial expansion in the loan portfolios of these institutions.

On a less rapid timetable, there is also the need to build a system of loan guarantees to support long term lending to small and medium sized businesses. This requires more careful design because these loans are riskier and the dangers of abuse and fraud are substantially greater. The goal would be something similar to a guarantee program that exists in Germany where the risks are distributed across different institutions. One might imagine, for example, 25% of the risk being covered by the Federal Home Loan Bank Board, 25% by the Federal Reserve System, 25% by the Treasury, and the final part being carried by the originating institutions. Since these guarantees are designed to support probabilistic lending at the local level, it is assumed that there will be periodic losses from businesses that fail, but these losses would be spread across strong institutions whose revenues would be increased by the stronger growth resulting from more vigorous lending to small and medium sized firms.

The idea here is to diminish the role of the stock market financing in the U.S. economy by increasing the share of bank lending to finance long term business investment. The reason for emulating the financing pattern that has long been followed by Germany is that there is an affinity between high rates of innovation and greater reliance on small and medium sized

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enterprises that are frequently family owned. With this shift, those in charge of small and medium-sized enterprises would have a viable alternative to having their firms listed on public exchanges and they would be effectively insulated from the short term time horizon problem that plagues publicly traded corporations. There would also be much enhanced opportunities for employee owned firms to flourish since they would no longer face discrimination when attempting to borrow.

It will, of course, take time for these emergent financial institutions to learn the specific skills required to be effective as financers of small and medium sized firms. The clean energy guarantees and the broader guarantee program would help to facilitate this transition. But over time, the guarantee programs should be focused on recently created firms since lending becomes progressively less risky as small and medium sized enterprises become more established. And during economic downturns when these firms experience temporary difficulties, the decentralized financial institutions would be able to maintain lending by increasing their own borrowing from the Federal Reserve or the Federal Home Loan Bank system.

This strategy requires that millions of citizens be willing to change the way they invest their savings. At present, roughly 92 million people belong to credit unions in the U.S. and these institutions control about 10% of consumer deposits—about $600 billion. With such a strong base at the start, it is plausible that people would be willing to move much more of their savings from big commercial banks to credit unions once they saw a broad effort to revitalize the credit union sector. The goal at the end of a transition period would be to reverse the current ratio with 90% of deposits in the credit unions and only 10% left for commercial banks.

Nonprofit Investment Banks
However, shifting deposits from commercial banks to credit unions does not address the flow of resources from households to purchase securities. As we have seen, those flows empower brokerage firms, giant mutual funds, and support the deeply flawed governance of giant corporations. The next step is to create new nonprofit investment banking firms that would be able to underwrite securities to finance government agencies, infrastructure investments, and to support lending by the expanded credit union sector.

These new institutions could be created as entities jointly owned by large public pensions funds or by other nonprofit financial intermediaries. They would compete directly with existing investment banks that underwrite bonds. This would give local governments an alternative to dealing with existing Wall Street firms when they decide to issue new municipal bonds. These institutions would also be able to finance large-scale infrastructure projects. But in evaluating these infrastructure projects, these nonprofit investment bankers could add an additional creditworthiness criterion. They would also consider whether the planning of the project involved sufficient democratic input and engagement from citizens in poorer and more marginal communities.

Finally, these new institutions would also be able to securitize loans written by nonprofit financial intermediaries. For example, loans to individuals and businesses to finance solar power could be consolidated into bonds that would be sold to investors. Through this instrument, the credit unions would have an infusion of new capital to expand further their lending activity. To be sure, this securitization process would have to be carefully regulated to prevent any participants from playing the “pass the trash” game” that was so central to the subprime mortgage disaster. But with all of the key participants operating on a nonprofit basis, the incentives for large-scale fraud would be diminished.
The issuance of these bonds would provide individual investors, pension funds and other institutions a safe and socially productive outlet for their savings. The intuition here is that most people are not looking for outsized returns on their personal saving; they want primarily security and predictability. Bonds that reliably paid 3% or 4% per year would be attractive, especially when people understood that these investments were contributing to sustainable economic growth.

Corporate Reform

There is already a social experiment underway to reshape the corporate form in the United States. Several states have passed legislation that creates a new kind of corporation called a beneficial corporation—a B Corporation—that operate under different rules than standard corporations. The standard corporate rules require the firm’s managers to maximize profits and shareholders have a potential legal case if they can prove that management has failed in this obligation. This means, for example, that a firm that was too oriented to protecting the environment or too kind to its employees might be found by the courts to have neglected profit maximization. Management at B Corporations, in contrast, is free to place other goals ahead of profits. The nonprofit behind this reform has created a monitoring system to make sure that these firms do meet higher standards in their environmental practices, labor practices, relationship to the local community, and disclosure practices. However, B Corporations retain the basic structure in which the members of the firm’s board of directors are elected by the shareholders alone.

The fact that nineteen states have passed beneficial corporation statutes, and that there are already 1,000 firms incorporated under these statutes suggests a broad interest in improving the

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65 Such firms are allowed to prioritize other goals such as environmental sustainability or good working conditions over profitability. Dana Brakman Reiser, “Benefit Corporations—A Sustainable Form of Organization?” *Wake Forest Law Review* 46 (2011): 591-625.
corporate form. However, the success of this initiative requires a further step—that B corporations be managed with a stakeholder board in which employees choose 40% of the board members, 40% are chosen by the shareholders, and the remaining 20% are chosen by other constituencies. (We can call these resulting firms “B+ Corporations to signify the additional requirement of stakeholder boards.) This type of structure is absolutely necessary to overcome the weaknesses of standard corporate governance arrangements. By balancing the influence of employee representatives with those of shareholder representatives and denying both groups a permanent majority, three things are accomplished. First, the strategic management of the firm is understood as a political task in which it is necessary to build effective coalitions across interest groups. Second, by acknowledging the problem as one of balancing conflicting interests, it becomes easier to develop effective managerial strategies. On the one side, the employee representatives can be expected to focus on preserving their jobs for the long term, while shareholders will press for profitability right away. The need to secure majority support will push managers to identify those strategies that effectively balance these different time horizons. Finally, in this political context, it should be substantially easier to restrain the compensation of top executives.

One of the most important advantages of this stakeholder structure is that it makes it easier for founding entrepreneurs to keep the company independent if that is their preference. With conventionally structured firms, as soon as an outsider has purchased the majority of the outstanding shares, they control the firm. But with a stakeholder board, even if one bought up all the shares, one would control only 40% of the seats on the corporate board. In other words, entrepreneurs would be able to raise funds in the stock market, and as long as they maintained
good relations with their employees, they could avoid a forced sale to outsiders. For this reason alone, some entrepreneurs would gravitate towards the B+ corporate form.

If we assume that the statutes were reformed in this way, then the voluntary choice by some firms to incorporate as B+ corporations could set in motion a cascade over the following years. As a group, we would expect that B+ corporations would be better managed and return a higher share of profits to the shareholders than conventional corporations where top managers will keep trying to maintain excessive levels of compensation. As a consequence, B+ corporations would come to be preferred by shareholders and would enjoy lower cost of capital. This would put pressure on conventional corporations to reconsider their management structures. One can easily imagine, large institutional investors demanding that firms follow this alternative path.

As the population of B+ corporations grew, this alternative structure could then emerge as an effective response to incidents of corporate malfeasance. Prosecutors and judges have faced a chronic problem of devising appropriate penalties for corporations that have been found to behave badly. The practice that is common now is to insist on the payment of huge fines, but it is widely recognized that this has relatively limited deterrent effect since the penalties do not hurt the top executives themselves. A better alternative would be for prosecutors to negotiate with the firm’s Board of Directors to get them to reorganize as a B+ Corporation because their previous structure did not work to keep their executives from violating the law. This might be done at first informally and then it could be codified into law by Congress that the third time a firm was found guilty of malfeasance, it would be forced to reorganize in this way.

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66 Block, “Capitalism Without Class Power.”
After some time, the expectation is that the old form of incorporation would represent a small share of even the largest firms. The migration of most firms to stakeholder boards would, in turn, have a significant effect on the political role of corporations. For one thing, stakeholder boards would be less supportive of the huge investments that firms put into partisan political activities. To be sure, stakeholder boards would still want the firm to have good relations with legislators and regulators, but they would be much less likely to continue the pattern where many corporations donate only to Republicans. But even more importantly, stakeholder boards would be less likely to participate in class-wide mobilizations such as participation in a capital strike against a government believed to be hostile to business.

Historically, corporations have slashed their investment plans when elected left-wing governments have announced ambitious redistributive programs or substantially tighter regulation of business. This “loss of business confidence” tends to produce an economic slowdown that diminishes the popularity and legitimacy of that new administration. But with stakeholder boards where the employees control 40% of the seats, it cannot be assumed that there would be a majority vote for a drastic reduction in investment spending. After all, redistributive policies put more money in the hands of consumers, so for firms making consumer goods, there would be a legitimate argument that the firm should, in fact, increase its productive capacity. If the issue were tighter regulation, B+ corporations had already voluntarily agreed to meet higher regulatory standards, so they would have less reason to see new regulations as threatening.

To be sure, some B+ corporations might decide to participate in a politically-motivated investment slowdown, but as the number and size of B+ corporations increases, the economic damage done by a capital strike is likely to diminish. With some firms maintaining investment levels, the elected government could use other kinds of stimulus, such as higher infrastructure
spending and lower interest rates, to sustain demand. Some striking firms might recognize that they were losing opportunities leading them to defect from the class-wide action. In short, the chances of the elected administration surviving such a challenge would increase.

Global Level Reforms

As explained earlier, part of the background to this reform vision is the idea of synergies across multiple levels of contestation. Certain victories at the national and supranational regional level would make it easier to accomplish reforms at the global level that could, in turn, facilitate further progress at lower levels. This is particularly important in reference to the giant U.S. financial institutions that played such a central role in the 2008 Global Financial Crisis. The reality is that the unique position of the U.S. in the global economy has empowered these Wall Street firms. With the dollar being the world’s major reserve currency and the U.S. running chronic balance of payments deficits, hundreds of billions of dollars of foreign capital flow into the U.S. each year with Wall Street firms handling most of these transactions. It follows that disempowering these firms requires reforms both at the national level and at the global level.

The good news is that the severity of the 2008 crisis and its aftermath has led to a broad recognition around the world that the existing global financial arrangements are irrational. 68 Governments in China, Brazil, Japan, and the European Community have been increasingly critical and have advanced valuable reform ideas. In some cases, there are already tangible steps in the direction of reform being proposed here. I would emphasize four steps as the most critical:

1. It is irrational and undesirable for the world’s remaining superpower to be importing capital from the rest of the world. The U.S. should be moving its current accounts back to balance by

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significantly reducing its imports, especially petroleum, increasing exports, and substantially cutting back on its global geo-political commitments, particularly the vast empire of foreign military bases. Moreover, there is an urgent need to reform the existing tax system that incentivizes U.S. firms to invest abroad and to book profits in foreign tax havens.

2. There should be an international financial transactions tax to dampen speculative international capital flows.

3. The dollar’s role as the dominant international currency should be phased out, ideally by moving towards the kind of international financial mechanism that J.M. Keynes proposed in the 1940’s. He argued for an International Clearing Union that would automatically provide credits to nations in a deficit situation. ⁶⁹

4. There needs to be significant expansion in the scale of global development banks that would relend funds for productive uses across the developing world. This would provide a productive outlet for global savings that now often move into speculative and destabilizing investments. But this expansion should occur simultaneously with major efforts to expand the democratic accountability of these lending institutions. Ongoing discussions of the Green Climate Fund as part of the UN climate change initiative, of the BRICS bank that is to be developed by Brazil, Russia, India, China, and South Africa, and China’s proposal for a new Asian infrastructure bank all point in this direction.

These global reforms would help reinforce the democratization of finance within the United States through a number of different channels. First, taxation on financial transactions would increase incentives for more productive forms of lending. Second, the phasing out of the dollar’s reserve currency role would weaken the dominant Wall Street firms by reducing their

access to capital inflows from abroad. Third, the expansion of the role of development banks could internationalize the model of nonprofit and sustainable lending. Essentially, people around the world could purchase guaranteed bonds for their retirement portfolios from these global development banks that would relend the funds to nonprofit banks in different nations that would invest in infrastructure and clean energy. This would help to establish a new channel that would direct savings directly into productive investments.

**Part V: Conclusion**

The remaining question is whether this proposed set of reforms constitutes a real utopia. This requires overcoming two objections—the first centers on achievability and the second centers on utopianism. The first issue is whether the proposed reforms would be sufficient to achieve the proposed goal of subordinating the market to democratic politics. Specifically, is it realistic to imagine that these reforms—even after a generation or two—would be sufficient to overcome the concerted resistance of propertied interests? The second issue is whether these reforms would actually constitute a utopia. After all, even if the project were successful, there would continue to be great inequalities of wealth and income and profitability would still dominate in some sectors of the economy.

I will address the second issue first. A real utopia is not intended to make all problems go away in a single instant; that only happens in schemes that cannot possibly be realized. What makes something a real utopia is that the changes are actually feasible and they potentially could shift the balance of forces in favor of further reforms and improvements. The proposals advanced here for democratizing finance accomplish this end by significantly expanding the scope of democratic politics and weakening the resistance of existing elites. For example, as the
reform process continued, it would become steadily easier to impose taxes that increased redistribution from the wealthiest families to the poor. Moreover, the process of reform would create a new political and economic context in which it would be easier to address and solve remaining social problems of inequality and exclusion.

The first objection is more challenging, since we do not have a precise way to think about the ability of propertied interests to defend their privileged economic, social, and political position. However, Piketty’s historical data on the wealth holdings of the top 1% provides us with some important clues. Piketty implies that for centuries, the top 1% commanded the majority of society’s wealth. He provides data to show that this continued to be true through the 19th century in France, England, and Sweden. However, between 1910 and 1970, the share held by the top 1% declines precipitously to about 20% in each of these nations. While Piketty attributes this decline to the impact of two World Wars, it seems more appropriate to explain it by the arrival of mass democracies in which active socialist movements agitated for greater economic equality. This is supported by the fact that in the U.S., where mass democracy came earlier, the share of the top 1% in the 19th century fluctuated between 25% and 40%. Their share peaked at 45% in 1910 and then leveled off at 30%.

The data strongly suggest that the arrival of mass democracy, despite all its limitations, forced propertied interests to accept a very substantial reduction of their wealth holdings. In England, the decline was from 70% in 1910 to slightly more than 20% in 1970. 70 Hence, it would seem plausible that systematic campaigns to bring about deep democracy could push their

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70 To be sure, Piketty’s argument is that after 1970, the historic tendency for the rich to increase their share reasserted itself. However, his actual data shows, even for the United States, that the increase in wealth holdings since 1970 have been relatively small. The English data suggests an increase from 20% to 30% and the U.S. increase is considerably smaller. To be sure, the data might be distorted by the systematic hiding of wealth in off shore tax havens. Still, it seems pretty clear that much of the redistribution that happened between 1910 and 1970 has not yet been reversed.
share down substantially lower—perhaps to something between 5% and 10%. Moreover, it also seems that there has to be a tipping point where a diminished share of total wealth also begins to diminish the political capacity of the very rich. As the great fortunes start to diminish, it might no longer be so attractive for the ultra-wealthy to invest money in media empires where economic returns are uncertain. Similarly the vast investments in political influence of the Koch Brothers would be surprising if their fortune were to shrink from $100 billion to $7 or $8 billion. Perhaps, after that tipping point, new policies could reduce the share of the top 1% might be reduced to just 2 or 3% of all wealth.

However, it can certainly be argued that the conservative backlash that has dominated U.S. politics since the 1970’s was, in part, the result of an organized effort by the very rich to reverse the contraction of their share of wealth that happened between 1910 and 1970. And Piketty’s data shows that they were spectacularly successful in increasing the 1% share of income from 8% in 1971 to 20% in 2012. However, Piketty’s data also indicate that the comparable trends in Europe have been considerably weaker. This suggests that the strength of the conservative reaction in the U.S. has been relatively unique. I would suggest that it is not a consequence of the inherent structural power of propertied interests in the U.S., but it should rather be understood as similar to a perfect storm—the confluence of several distinct factors. While propertied business interests did push hard, they were successful because of the powerful backlash against the social movements of the 1960’s, the toxic legacy of racial antagonism, the sudden collapse of the New Deal political coalition in the 1970’s and the resulting weakness of progressive infrastructure, and perhaps most importantly, the fact that most citizens in the United
States had absolutely no idea between 1981 and 2008 that a vast redistribution of income to the rich was going on. These contingencies suggest that the perfect storm could be reversed.

But the precedent of egalitarian gains in the period between 1910 and 1970 is not sufficient to make the case that the resistance of propertied interests could be overcome in the 21st century. The key issue is the image that Al Gore popularized of the frog in the pot on the stove that is slowly getting hotter. Will the frog be complacent and be boiled or will there be a point when the frog realizes the danger and jumps. The transition strategy that I have outlined here is based on avoiding a direct confrontation in which property owners are threatened with expropriation. Instead, they would be faced with a very slow and gradual erosion of their power and influence. But it does seem probable that rather than suffering death from a million different reform initiatives, they would jump and precipitate a confrontation in which they sought to destroy the reform forces.

Let us assume that this moment of confrontation came within five to ten years of the start of the reform process. There would have been some significant deepening of democracy, but the alternative economic institutions would still represent perhaps as little as 30% of the overall U.S. economy. But let us also assume that by that point, these reforms would have blurred current partisan lines as communities, even in the most conservative states, had seen the advantages of these institutions for locally-led processes of economic development. What might happen in this confrontation? For one thing, it seems improbable that propertied interests would rely on a military coup or the seizure of power by the intelligence apparatus. The risk is simply

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71 A number of studies suggest that even after 2008, most respondents still underestimated the degree to which income distribution had been skewed towards the 1%. But the key point is that these studies found that most people, including conservatives, had a preference for a more egalitarian income and wealth distribution than exists now. Lawrence Jacobs and Benjamin Page, *Class War?* Chicago: University of Chicago Press, 2009; Michael Norton and Daniel Ariely, “Building a Better America—One Wealth Quintile at a Time.” *Perspective on Psychological Science* 6:1 (January 2011): 9-12.
too great that obvious violations of democratic norms would have the Nixonian consequence of strengthening the reform movement and isolating the elite plotters.

The far more likely scenario is that the wealthy would declare war on the reformist administration in Washington and declare that its radical policies were destroying the economy. They would time their attack with the electoral cycle in the hope that the next election would shift power to the conservative party. They would then use the venerable methods of capital strike and capital flight to provoke fear and to “prove” to the public that the reformist policies were wrecking the economy. This would be an attempt to produce the transition trough in which people suffered a real reduction in living standards as part of the price for creating an economy that did not privilege private capital.

At this point, it seems likely that two factors would prove decisive in this confrontation. The first is the global political economic context. If global institutions, such as the International Monetary Fund, were supportive of the reformist administration in DC, then the departure of flight capital could be offset by government borrowing and borrowing by the network of nonprofit financial institutions. Assuming that the government was then able to use both deficit spending and expansionary monetary policy, it would be possible to offset some of the consequences of big business disinvestment.

This, in turn, would shape the second critical factor—the choice that the electorate would have to make. Quite obviously, if the partisan divide in the U.S. were the same as in the current period, the prospects would not be good. However, if one assumes that the democratic economic program had strong grassroots support throughout the country, then this key election could be framed as a confrontation between democracy and oligarchy in which the oligarchs were deliberately imposing pain on everyone else. Since new democratic practices would have
expanded the public’s understanding and ability to talk and think about politics, it is not improbable that the democratic forces could win this confrontation.

But the other key point has to do with the timing of the confrontation. The more time passes before the critical confrontation, the greater the chances that the reform forces would win since their share of the economy would be larger and they would probably have more global support. But if the confrontation erupted earlier, say just two or three years into the reform process, the chances of a defeat would be substantially higher. But if the reform movement built this possibility into its organizing strategy, it would be able to recover from this early defeat. Activists would redouble their efforts at the local level and at the global level and wait for a more auspicious moment to intensify the battle at the national level.

In short, there is no certainty about the ultimate viability of this strategy. Much depends on global politics and the unfolding of crises around the environment and global health. But the central global process of the last two hundred fifty years has been the forward march of democratic governance. Before the French and American Revolutions, almost the whole world was ruled by monarchies or other kinds of autocracies. Today an ever growing share of the world’s population lives in societies that are, at least, formally democratic. And as we know from Tahrir, Tiananmen, and other squares, the aspiration for democratic governance is now almost universal. So if we understand socialism as the project of deepening democracy and subjecting the market to democratic control, it is still very much on the historical agenda.