John Roemer's vision of coupon socialism represents a significant contribution to the reconstruction of socialist theory. By separating the idea of socialism from the historic goal of eliminating private property, Roemer has opened a broad terrain for debates about alternatives to existing forms of capitalism.

Roemer's framework is, however, vulnerable to two seemingly divergent types of criticisms. The first is that his vision of socialism does not do enough to expand the terrain of democratic politics. Roemer has repeatedly argued that increasing employee control of the workplace is not a necessary element of the socialist vision. In his view, an egalitarian distribution of profits is far more important than democratic control of the workplace. The second criticism is that Roemer's vision of the operation of the financial system in coupon socialism relies too much on Kornai's famous critique of the destructive consequences of 'soft budget constraints' in state socialist societies. As a consequence, Roemer fails to confront some of the other major design issues in constructing a socialist financial system.

This essay begins with this second line of argument. It will explore the different ways that financial systems can fail. The purpose of this is to suggest several different design principles that need to be considered in thinking through the financial structure of market socialism. But several of these design principles lead directly back to the issue of employee power at the workplace. In short, I intend to show that a more systematic focus on the design of financial institutions in market socialism leads to proposals that place greater emphasis on the exercise of power by employees at the workplace.
Problems of Financial Intermediation

Any vision of market socialism begins with the idea that individual business enterprises will operate in the context of competitive product markets, labor markets and capital markets. Firms that are more efficient, and hence more profitable, should be in an advantaged position relative to other firms in going to the capital markets and receiving additional finance. This requires some institutional mechanisms of financial intermediation by which the savings of individuals and firms are funneled to profitable firms and other productive uses. In Roemer's proposal, firms raise capital either by selling shares to mutual funds or by borrowing from banks. But other market socialist proposals suggest other financing mechanisms and a wider or narrower range of different financial intermediaries.

To gain leverage on these design questions, it is critical to identify the financial dangers that one wants to avoid. The first is the problem of soft budget constraints. The essence of Kornai's argument is that financial intermediaries in state socialist societies are unable to cut off flows of credit to inefficient firms because of the political costs of business failures. Since the large state-owned enterprises employed thousands of people and often provided transfer payments to pensioners as well, their failure would have disastrous political consequences. Moreover, attempts by the financial institutions to monitor these enterprises to weed out ineffective managers were also bound to fail because of the difficulty of accumulating meaningful data about firm performance. One firm might appear to be efficient only because it produces a scarce commodity that has been assigned a generous price by the planners, while a firm that appears to be losing money might actually be managed quite effectively.

Kornai's argument produced two conclusions. First, firms must be subject to hard budget constraints, so that badly run firms will be allowed to fail; but, since bankruptcy should only be a last resort, it also follows that financial intermediaries should have the opportunity to monitor the performance of firms in which they invest resources. Such monitoring can discourage firms from pursuing undesirable strategies or lead to the replacement of ineffective managers. For such monitoring to be effective, prices have to be determined on markets and firms must make information available in accordance with accepted accounting practices.

However, if it is desirable that firms not face soft budget constraints, it is also a problem if the budget constraints become too hard. It is possible, for example, for financial intermediaries to impose harsh conditions on borrowers. The simplest case is when the interest rates on loans are pushed to levels where financial intermediaries are able to claim a substantial share of the borrowing firms' profit streams. These financial intermediaries are able to extract rents because potential borrowers have nowhere else to go. Another danger is that financial intermediaries engage in openly predatory activity; forcing firms to accept direction and control from those financial institutions. This has been emphasized in the Marxist literature on the domination of industry by 'finance capital'.

Another critical aspect of brittle budget constraints is the withholding of credit from potentially creditworthy borrowers. Even mainstream economists now acknowledge that the financial markets are not balanced through the interest-rate mechanism. On the contrary, credit is always rationed by financial intermediaries by withholding credit from borrowers who are perceived to not be creditworthy. Since lenders tend to share the same criteria, this 'strategic non-lending' has been a major mechanism through which class power has been exercised. For example, the difficulty that worker cooperatives face in borrowing capital has been important in discouraging their development.

In theory, competition among financial intermediaries should always eliminate the dangers of brittle budget constraints. However, once problems of information in financial markets are recognized, it becomes clear why real financial markets often diverge from the neoclassical ideal. First, the ability of financial intermediaries to raise money depends critically on issues of trust and confidence. Neither households nor firms are likely to make their funds available to intermediaries who seem unlikely to make good on their promises. This creates a substantial 'first mover advantage' where the initial two or three financial intermediaries to establish themselves in a particular market are able to gain a major advantage in size and reputation. Moreover, since governmental regulations often play a central role in establishing and maintaining the soundness of financial intermediaries, it is quite common for the government's rules to privilege a few dominant institutions and to create obstacles to latecomers.

The second informational problem is the difficulty that financial intermediaries have in gaining accurate knowledge about potential borrowers. Even when borrowing firms operate within competitive markets and use common accounting standards, it is not easy to figure out the relative creditworthiness of firms. Financial intermediaries tend to respond to this difficulty by economizing on the expensive business of collecting and evaluating information and they rely instead
on signals and conventions to evaluate creditworthiness. If all the relevant institutions use the same signals and conventions, then even a financial marketplace with a high level of competition could produce brittle budget constraints.

A third problem is that financial intermediaries operating within competitive markets face the continuous temptation to invest in riskier types of investments because they promise higher rates of return. In recent years, there have been repeated episodes in which financial intermediaries have poured huge sums of money into activities that seemed relatively safe at the time, but which ultimately proved to be quite risky. Such episodes in the US include excessive lending to Third World countries in the 1970s, excessive lending for commercial real estate projects by Savings & Loans in the 1980s, excessive purchases of 'junk bonds' to finance leveraged buyouts in the 1980s by a range of different intermediaries and, most recently, costly speculation in financial derivatives by mutual funds, banks and hedge funds.

Many of these episodes have rested on asset price 'bubbles' where continuing appreciations in the value of a particular asset has created the illusion that prices will continue to rise indefinitely. Real estate and stock prices in Japan and rents on shopping malls and commercial office space in the US followed this pattern. Financial institutions lent billions on the expectation that the bubble would continue, but when the inevitable decline in prices came, many of the loans could not be repaid.

There is a slightly different pattern when new categories of borrowers are willing and able to borrow at a premium over the standard interest rate. In the early period when those new borrowers are able to continuously increase their borrowing, they have no difficulty in maintaining interest payments. But over time, as the magnitude of the debt increases without corresponding increases in the debtor's productive assets, the borrowers find it increasingly difficult to service the debt. When new lending stops, the financial weakness of the borrowers becomes apparent, and large quantities of debt go into default. This was the pattern of Third World and Eastern European borrowing during the 1970s and some of the 'junk bond' borrowing to finance corporate restructuring in the 1980s.

There are two dangers when financial intermediaries become too involved with these more speculative types of investment. The first is that the financial intermediaries will waste large amounts of capital and will suffer huge losses that will put their very survival at risk. This, in turn, raises the troubling problem of 'soft budget constraints' for financial institutions. In the US, the system of Federal insurance of deposits at banks and savings and loans has created something very close to a soft budget constraint. Bankers in pursuit of higher profits can pursue riskier investments without fear because they know that the government will have to bail them out to protect the depositors. But even short of such catastrophes, there is a second danger: financial intermediaries will channel funds to less productive uses because they produce higher rates of return. Hence, when faced with the choice between lending a hundred million dollars to a hedge fund or lending the same amount to finance expansion at a hundred different medium-size firms, the former is the path of least resistance because it involves substantially lower transaction costs.

Above and beyond these other problems, financial intermediaries can simply do a bad job in allocating capital. Poor allocation encompasses several different types of problems:

A. Divergence between private and social rates of return

There are many circumstances where the positive or negative externalities of particular types of investment can create a significant divergence between the returns to investors and the returns to the society as a whole. A perfectly efficient capital market could easily finance vast investment in nuclear power plants, while withholding financing from a range of different solar technologies.

B. The time horizon problem

The specific organization of financial intermediation can influence the time horizon on which borrowers attempt to maximize returns. Much has been written about how the organization of finance in Japan encourages firms to develop long-term time horizons, while US firms are much more oriented to the short term. The obvious advantage of the long term is that it encourages investments in intangibles such as research and development and human capital that have the potential of producing substantial future returns.

C. Ineffective monitoring of borrowers

As noted earlier, financial intermediaries face continuing pressures to economize on the collection of information about borrowers. Yet excessive economizing on information can lead to poor performance in differentiating between stronger and weaker borrowers.
For reasons noted earlier, there is no guarantee that this problem will be solved by competition among financial intermediaries. It is not difficult to imagine a circumstance in which the limited information gathered by creditors combined with certain shared preconceptions can lead to the systematic misallocation of capital.

Minimizing the Problems

This catalog of dangers suggests several design principles for organizing financial intermediation under market socialism. The first is the principle of political autonomy that is emphasized in Roemer's coupon socialism proposal. Each financial intermediary needs to be able to stand on its own feet within the financial marketplace. The intermediaries would be able to borrow funds from the central bank, but these borrowing rights would be contingent on effective performance. Insolvent financial intermediaries would be closed down by government regulators and their assets would be redistributed to their more successful competitors. By enforcing quite stringent definitions of insolvency, regulators would be able to discourage managers of these intermediaries from believing that they could risk being careless about the quality of their loan portfolios. However, for regulatory threats to be effective, it is critical that any particular financial intermediary not be allowed to exceed a certain maximum size. In this way, one can avoid the 'too big to fail' problem where government regulators feel compelled to bail out an institution whose failure would have devastating macroeconomic consequences. The logical path would be to establish a normal procedure by which the most successful intermediaries would periodically divide themselves into two successor organizations. This process of financial mitosis could create institutions with different kinds of specialties: a bank might, for example, divide between its large business accounts and its small business accounts. Moreover, this process occurring on an ongoing basis would assure that high levels of competition would continue among financial intermediaries.

A second design principle is the idea that financial markets should be segmented. In neoclassical theory, it is axiomatic that there should be the fewest possible obstacles in the way of moving capital to the activity with the highest rate of return. The policy implication of this axiom is that it is desirable to create the highest level of integration of capital markets within and between countries; but there are at least three different problems with this way of thinking. First, divergences between returns to investors and returns to society mean that greater financial integration makes it less likely that some socially valuable investments will be financed. Second, the greater the degree of integration of financial markets, the more funds are available to flow into certain types of speculative investments. This exacerbates the danger of speculative bubbles. Third, financial integration has the consequence of undermining the capacity of individual financial institutions to gather and analyze information about prospective borrowers. The simple logic of portfolio diversification means that a financial institution with opportunities to invest in a broad range of foreign or domestic assets will shift resources from the processing and assessment of loans to the analysis of these broader opportunities. In short, abstract financial information and analysis will tend to displace concrete knowledge about particular economic sectors or regions.

These problems can be significantly reduced by segmentation of the financial market, so that different financial intermediaries are constrained in terms of both the types of assets and the shares of different assets that they are allowed to hold. This means returning to a regime comparable to that in which Savings & Loans were largely restricted to mortgage financing, while commercial banks concentrated on business loans. It is critical to the idea of segmentation that there be vigorous competition among financial intermediaries in each segment, but competition across segments would be restricted.

For this reason, segmentation fits with the logic of the government using interest rate policies as a planning tool. In Roemer's model, the government would address the divergence between investor returns and social returns by establishing different interest rates for different activities. Hence, the costs of capital for business loans would be different from the cost of capital for mortgage loans. Furthermore, the government would manipulate these interest rates to keep parts of the economy from growing too quickly or too slowly. With integrated financial markets, such policies are unlikely to be successful: there are too many ways for financial intermediaries to shift resources from one activity to another. With segmented markets, however, the regulatory tasks would be far more manageable.

Segmentation also provides a partial solution to the deposit insurance problem. Those segments where there is an explicit or implicit governmental guarantee of household savings would be subject to far more stringent rules on the riskiness of assets than those segments where such a guarantee was absent.

Moreover, the combination of segmentation with the government establishing different interest rates for different segments would also
solve the strategic nonlending problem. One segment of the financial marketplace could be dedicated to financing non-traditional types of investment, such as employee cooperatives or local governments that wanted to launch productive enterprises. If institutions in this segment flourished, there would be expanding employment opportunities in nonhierarchical firms.9

The third design principle is that each financial intermediary should have strong incentives to invest in the development of specialized and concrete types of expertise. For example, an institution that is dedicated to funding public infrastructure projects needs to be able to identify poorly designed projects or incompetent environmental impact reports. Financial intermediaries who specialize in providing capital to high technology firms need to develop substantial technological expertise as well as the capacity to help technologically sophisticated managements solve their business problems.

The theoretical insight behind this principle is a criticism of neoclassical economics for placing far too much emphasis on allocational efficiency: on directing capital to activities with the highest rate of return. This has led to a systematic neglect of x-efficiency: the improvement in the output when specific quantities of capital and labor are brought together.10 As Leibenstein emphasized, the gains from improving x-efficiency far outweigh those that can be expected from improvements in allocational efficiency. The primary task of financial intermediaries under market socialism would be to contribute to higher rates of x-efficiency by providing successful firms with more resources and by exerting pressure on less successful firms to improve their practices. But both of these require that financial intermediaries develop specialized expertise.

Segmentation is an important first step to encourage intermediaries to develop these specialized forms of expertise but, if the costs of obtaining solid information on potential borrowers remain high, intermediaries will continue to have incentives to economize on information gathering costs. Intermediaries would continue to rely on potentially flawed signals and conventions. In a segmented financial marketplace, this is highly undesirable because borrowers would have a smaller range of potential lenders. Another undesirable consequence of high information costs would be a continued emphasis on abstract financial expertise over concrete specialized knowledge.

If the cost of information gathering about potential borrowers could be reduced, financial intermediaries would be more likely to develop specialized expertise and to engage in effective ongoing monitoring of borrowers. Reducing information gathering costs can be accomplished by making borrowing firms more transparent, so that an outside observer could make a more rapid and more accurate determination of whether the enterprise, or a specific project, is well managed and well conceived. It is in this context that the idea of workplace democratization becomes relevant.

Under most circumstances, a firm's employees are able to provide useful information about the effectiveness of a firm's management and the soundness of particular projects. A knowledgeable interviewer can gain extremely important insights by talking to a firm's employees, but it is not practical for financial institutions to gain information by meeting employees in bars after work. This is expensive, and management also has legitimate concerns about industrial espionage and the passing of proprietary information.

Moreover, the quality of employee evaluations of a firm and particular projects will improve in direct proportion to the amount of information that employees are provided by management. The more that employees are able to place their understandings of day-to-day events on the shop floor in the broader context of the firm's strategy and economic performance, the more reliable will be their assessments of management's claims.

Hence, there are significant advantages for outside financial intermediaries if a firm has a democratic process through which elected employee representatives meet regularly with management and are provided access to data on the firm's performance. If representatives of the financial intermediaries were to meet on a regular basis with these employees, they would have an excellent means to verify or call into question management's definition of the situation.11

This is, of course, a minimalist design for workplace democracy. Giving employee representatives access to financial information and meeting with them regularly does not give them any formal power over the firm's decisions. However, for the representation election process to be meaningful, employee rights to free speech would have to be significantly expanded, and employees would have to be protected from retribution for disagreeing with management. This alone would expand the democratic space within firms. It seems plausible that these small steps would create an environment in which management would feel the need to gain employee consent for many of its initiatives. If employees wanted to press management on a particular issue, this limited democratization would significantly increase their leverage. However, more dramatic steps to workplace democratization such as electing employee representatives to the board of directors might work even better to make the firm transparent to financial monitors.
It also follows that if financial intermediaries are to be information-intensive organizations, they need a relatively flat organizational structure in which employees with specialized expertise have considerable influence over the firm’s strategic direction. These employees need also to have a significant stake in the firm’s success. This could be accomplished by placing ownership rights over these firms in a diversified board of directors. For example, both shareholders and employees could choose 35 per cent of the board members, and the remaining 30 per cent of the board would be ‘public’ representatives. One job of these public representatives would be to curb any tendency by these financial institutions to emphasize the short term over the long term or to engage in predatory activities.

Two other mechanisms could handle the problem of excessive accumulation of power and resources in the most successful financial intermediaries. First, the process of financial mitosis would keep any particular institution from becoming too big. Second, relatively high taxes on firm profits and employee compensation would allow the society as a whole to benefit from the successes of the most effective financial intermediaries.

Conclusion

It is to Roemer’s credit that his work forces socialists to confront critical questions about the design of financial institutions under socialism. As Kornai’s work has shown, the long neglect of these issues by socialist intellectuals has had dire consequences. Moreover, clarifying our theories about how financial institutions should work under socialism can also sharpen our critique of capitalism and even suggest promising paths for structural reform. But the main argument of this paper is that creating the most effective financial structures is inextricably linked to expanding opportunities for employees to exercise power and influence at the workplace. In a complex socialist economy, one of the central challenges is to improve the flows of information and raise the quality of decision making at the enterprise level. This requires new types of financial intermediaries and greater workplace democracy.

Notes