This essay is an effort to provide a “real utopian” (Wright 2010) vision of how the financial system could be reorganized in the U.S. and globally in a way that would facilitate stable and more sustainable economic growth while increasing the possibilities for egalitarian reforms that would subordinate the economy to democratically-accountable government “of the people, for the people, and by the people.”

The existing financial system—both in the United States and globally—failed spectacularly in recent years; it fueled a disastrous bubble in mortgage financing, and when the bubble burst, the collapse of financial institutions brought the world to the brink of a global depression. While a 1930’s style crisis was avoided, recovery since 2009 has been slow and unemployment levels around the world remain at elevated levels. The need for radical reform of both the U.S. and the global financial order is obvious, but we have few existing visions of a reorganization that would be both radical and realistic. The present essay is an effort to suggest some of the outlines of an alternative organization of the financial system.

The proposal rests on a specific diagnosis of what features of financial organization produced the recent crisis. It also addresses both the national and global levels of the financial system since the crisis very much reflected the intersection of national and global dynamics.

But it is also important to emphasize that this proposal is a work in progress; this is the initial version, but the intention is that it will be revised extensively over the next six months. These improvements are expected to come from two sources. First, there is a need for more research to deepen my knowledge of specific aspects of the global and domestic financial systems. This is an extremely complex and broad topic and there are many places where more data and more information are needed. Second, the comments, suggestions, and criticisms of colleagues will help to refine and strengthen the arguments.

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1 I am grateful to Miriam Joffe-Block, Matthew Keller, and Lucas Kirkpatrick for conversations that generated some of the ideas that are included here. I am also happy to acknowledge support for the Ford Foundation for this project.
As with the construction of any “real utopia”; this will advance only if it becomes a collective project. What we need ultimately are dozens of scholars—drawn from a broad variety of different disciplines—working collectively to imagine a more democratic financial system. The present piece—even if it ultimately reaches a more finished version—is intended primarily as a provocation to launch that kind of intense collective effort to address these same issues.

GETTING THE DIAGNOSIS RIGHT

Several key aspects of the financial meltdown have been neglected in most accounts of the crisis. The first is that almost everybody focuses on the speculative investments, particularly the collateralized mortgage obligations that ultimately went bad when default rates on home loans started rising. These arguments are correct; there was a radical deterioration in lending standards that included dramatic increases in the prevalence of predatory lending, especially in minority neighborhoods. It is also true that under a system of extremely lax regulation, investment bankers had very powerful incentives to accelerate their sales of mortgage-backed securities that were of dubious value. Finally, the various agencies and actors who are supposed to work as circuit breakers to stop irrational financial practices were asleep at the switch. This includes both federal regulators who shared Alan Greenspan’s exaggerated faith in the capacity of financial institutions to self-regulate and the credit rating agencies that responded to economic incentives to grant Triple A ratings that were not warranted.

1. Systematic underinvestment.

But it is also important to emphasize that in the period up to 2007, when there were huge flows of capital available to finance dubious mortgage lending, there were other sectors of the U.S. economy that were facing acute credit scarcity. Specifically, small and medium sized enterprises were finding it extremely difficult to raise capital needed to expand their operations. The problem was particularly severe for small high-tech firms that were pursuing the commercialization of new technologies. Many of them were perishing as they crossed the “valley of death” —the period between a laboratory breakthrough and having a commercial product. Since numerous studies have shown that small businesses account for a very large share of new job creation, their problems in raising capital slow the economy’s ability to produce new jobs.2

There were also many infrastructure projects—including rebuilding of decaying bridges, sewer systems, and water treatment plants—that were being deferred because of the difficulty that local governments faced in raising the needed capital. In fact, by 2009, the American Society of Civil Engineers estimated the total cost of rebuilding the

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2 The argument here rests on the idea that economic growth does not have to be environmentally destructive. In fact, the proposals here are consistent with a shift from quantitative growth that emphasizes more output to qualitative growth that improves the quality of life and protects the global environment (Block 1990).
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 sources or improving mass transit and inter-city transportation to reduce the wasteful dependence on the automobile.

In short, it wasn’t just that the financial system was allocating capital to speculative investments that were producing extremely high, albeit unsustainable, rates of return for certain market participants. The other side of the story was that the financial system was simultaneously investing far too little in potentially highly productive activities such as small and medium sized enterprises and needed improvements to the nation’s infrastructure.³

To be sure, some of these neglected forms of lending had a long history. The federal government created the Small Business Administration in 1953 precisely because small businesses were having difficulty raising money from banks. And at repeated moments in U.S. history, the federal government has stepped in to create specialized financing mechanisms to build new infrastructure from the intercontinental railroad in the 19th century to the interstate highway system in the 1950’s.

But the neglect of small business lending by the financial system is a problem that has grown considerably worse over the last thirty years. The reason is relatively simple. The banking industry has undergone a tremendous process of centralization as a relatively small number of banks that were deemed “too big to fail” (TBTF) used this advantageous position to swallow up many medium-sized banks that, in turn, had merged with or displaced an even larger number of small banks (Dymski 2011). The consequence was that by 2008, 40% of all consumer deposits were concentrated at just 5 giant banks. The comparable figure in 1984 was 9% (Zingales 2009).

These giant banks could only manage their geographically dispersed operations by using rigorous efficiency criteria to determine how to deploy their human and financial resources. By these criteria, keeping local loan officers on staff to accumulate portfolios of small business loans could not be justified. The ratio of what such a loan officer would earn as compared to what he or she would earn for the bank could not be justified.

But, of course, these banks did not completely abandon the small business sector. They sought instead to eliminate the high staffing costs of small business lending through automation; computer programs would be used to score and evaluate loan applications. While bank officers might be given some flexibility in adjusting the cutoffs for creditworthiness to reflect local conditions, the consequence was inevitably a sharp decline in the risk of the bank’s small business portfolios. When a small business wanted

³ There was also a distinct underinvestment in this period in education as a consequence of rapidly rising costs of higher education that created substantial barriers for young people from households in the bottom half of the income distribution [Newfield 2008]. Moreover, the failure of the United States to invest in a system of universal, high quality childcare for children two to five significantly undermines the effectiveness of current education spending.
a loan that was outside of the computerized parameters that predicted a high probability of repayment, the loan would be denied.

In short, rationalization on the part of large banks meant that they economized on accumulating the local knowledge that might have led in earlier decades to taking risks in small business lending. And with the largest banks accumulating a virtual monopoly of consumer deposits, small businesses routinely had nowhere else to turn.

Similarly, underinvestment in infrastructure has worsened in recent decades as all levels of government have been struggling with a fiscal crisis. From the 1930’s through the 1970’s, the federal government either directly or indirectly underwrote much of the cost of infrastructure, some of it through revenue sharing programs. But as this federal support declined, state and local governments faced tighter fiscal constraints and were limited in the additional debt they could take on to finance infrastructure projects.

**2. Active Engagement by Government.**

A second often neglected aspect of the diagnosis is to recognize the degree to which the existing financial system is dependent upon the continuous and active engagement of government. Many writers attribute the financial meltdown to “deregulation” of the financial sector—suggesting that the government simply abandoned its oversight of this critical industry. But the reality is much more complex. There was a very significant shift in the regulatory rules and government regulators, such as bank examiners, were told that they should rely to a greater degree on self-regulation by firms in the financial industry.

But, at the same time, government agencies remained intimately involved in the day-to-day activities of financial institutions. In fact, government regulators approved the development and sale of credit default swaps as a mechanism to give financial institutions more options in their management of risk (Tett 2009). Regulators gave their official blessing as financial firms increased the amount of leverage they used in their portfolios. And, of course, government officials repeatedly made clear that they were committed to rescuing those financial institutions that were deemed “too big to fail.”

But the point goes substantially deeper. The reality is that in a market economy, lending money to others is a very risky business. Whether the borrowers are consumers or businesses or nonprofits, they are at risk to make bad decisions that make it impossible for them to pay back the loans. Moreover, even when the borrowers do everything right, they might find themselves battered by harsh economic winds—a recession or the collapse of a particular industry or of a local economy—that also prevents them from keeping up payments on their debt. Moreover, the longer the term of the loan, the greater the risks for the financial institution that errors or malfeasance by the borrower or changing economic conditions will lead to a default.

In the 19th century, governments recognized that if they wanted banking institutions that provided some kind of longer term loans, they were going to provide
those institutions with some protections from the vagaries of the marketplace. The most
direct form of this was the development of central banks as “lenders of last resort” who
were prepared to help financial institutions stay afloat during economic downturns by
extending them as much credit as they needed. But other governments went even further
than this by providing more specific guarantees that helped backstop key banks that were
making important loans for industry or infrastructure.

One of the ways that the U.S. paved the way for recovery from the Great
Depression of the 1930’s was to provide additional guarantees that further protected
banks from market-driven losses. A system of deposit insurance dramatically reduced
the threat to banks that depositors would run for the exit if a bank’s loan portfolio had
turned problematic. At the same time, the system of mortgage guarantees by the
Veterans’ Administration and the Federal Housing Administration helped to persuade
financial institutions that they could bear the risk of thirty year mortgage lending. In
addition, the creation of the Federal Home Loan Banks and Fannie Mae provided local
lenders with continuous access to relatively cheap credit (Minsky 1986).

Over the years, direct federal lending and additional federal guarantees and loan
subsidies have been added to the mix to support the growth of lending to students to
finance higher education, lending to finance U.S. exports, and lending for clean energy.
In a word, there is no such thing as a purely private credit-provision system in the United
States or in any other advanced economy. The system for providing long term financing
for households, for businesses, and for nonprofits depends on multiple forms of public
support for the private financial system.

This is yet another reason that it is critical to think of systematic reforms of the
existing public-private mix. We know that without massive federal intervention in
2008-2009 through the Congressionally-approved Troubled Asset Relief Program
(TARP) and trillions of dollars of additional emergency lending by the Federal Reserve
Board, virtually every financial institution in the U.S. would have collapsed. Since there
is no possibility of abandoning a substantial public role in credit provision, the only
question is how to reshape the current system to meet society’s needs for both economic
stability and improved allocation of credit.

3. Destructive Competition between Giant Financial Institutions and their More
Nimble Competitors.

The third often neglected aspect of the 2008 Wall Street crisis is that it cannot be
explained simply by the existence of a relatively small group of giant, too-big-to-fail
financial institutions. This was a necessary element, but it was not sufficient.
Generally, when industries are dominated by an oligopoly, they tend towards cautious
policies since the firms are already able to extract very substantial rents simply because
of their structural position. The fact that the TBTF institutions deviated from this and
pursued extremely risky strategies requires explanation.
The extraordinary concentration of deposits in a small number of institutions coincided with a counter-tendency. The development of new computer and communications technologies empowered small, highly nimble firms that were subject to very few regulatory constraints. Some of these small firms were organized as hedge funds, others as private equity, and still others as individual investment advisors. But the point is that a very small operation—one or two key partners and a handful of employees—could suddenly gain access to literally hundreds of billions of dollars of capital (Lowenstein 2000).

As these small firms emerged, the TBTF courted them because they were a lucrative source of business. A hedge fund with a $100 billion portfolio would do a huge amount of trading and TBTF’s would compete to be the institution that cleared these trades. The necessary quid pro quo was that the giant institutions made available generous credit lines that allowed these small firms to engage in highly leveraged trading strategies.

But behind these forms of cooperation, the small firms represented a very substantial competitive threat to the TBTF institutions. First, the small firms because of their size and their freedom from any regulatory restraints were able to move more quickly into profitable trading opportunities. Second, and probably more significant, the small firms provided an alternative and often more attractive career opportunity for the giant banks most talented people. The bank’s skilled traders and portfolio managers were continually tempted with the possibility that they could increase their already substantial earnings by a factor of ten or a hundred if they became successful in running their own small financial firms.

It was this competitive threat that fueled the race to the bottom. Since the TBTF firms had to retain and motivate their traders and portfolio managers, they had to give these employees some freedom to emulate the smaller nimble firms. Hence, they also, began trading with substantially higher levels of leverage. But TBTF firms also took advantage of their structural position to invent new types of financial instruments—an option that was not available to the small firms that had little regular contact with regulators.

So, for example, bankers at J.P. Morgan developed the modern credit default swap as a way to open up a new profit-making opportunity. Their regular access to regulators gave them the opportunity to persuade government officials that this would be a good way to manage risk within the global economy (Tett 2009). But, of course, the way things worked out, this proved to be a mechanism to concentrate risk and increase the systemic risk in the global economy.

In short, the counterfactual is that in the absence of the competition from small firms, TBTF firms would not have had to engage in these kinds of innovative strategies. It was, in short, the sometimes cooperative, sometimes competitive, relationship between giant institutions and small firms that put the financial system on the disastrous road to greater and greater risk taking.
But this history also suggests another point. The fact that tiny firms with twenty employees could compete head-to-head with giants such as the Bank of America indicates that there are very limited economies of scale in the financial sector. To be sure, the TBTF banks got that way because federal policies enabled them to gain control over a disproportionate share of consumer deposits. But computer and communications technologies have leveled the playing field, so that traders and portfolio managers at small firms can now out-compete traders and portfolio managers at huge institutions. At the highest level, finance is now a knowledge industry and small smart firms are able to generate knowledge and profit from it just as well as the giants.

The Domestic and the Global Dimensions of the Crisis

The last important dimension of the diagnosis is to understand how domestic and global factors interacted to produce the crisis. There was enormous variation in how vulnerable national financial systems were to the global crisis; nations like Iceland and Ireland suffered dramatic financial collapses, while both Canada and China’s financial institutions weathered the crisis with relative ease. But it would be mistaken to look at the crisis as simply a question of the relative soundness of different national financial institutions.

On the contrary, the global economy has its own governance structure that consists of formal institutions such as the International Monetary Fund, the World Bank, the Bank for International Settlements, the G8 and the recently created G20 and a variety of formal and informal rules that are designed to shape the behavior of both national governments and financial institutions. But the effectiveness of these institutional arrangements is closely linked to the strategies pursued by the world’s dominant economic power—England in the 19th century and the United States since World War II.

The global economic crisis in the period between World War I and World War II was directly linked to a crisis of hegemonic succession as England no longer had the resources to manage the global economy and the United States was not yet willing to take on the task of global economic leadership (Kindleberger 1973; Block 1977). The transmission belt was a series of imbalances that were papered over by international financial flows that ultimately proved to be unsustainable. When the flows stopped, contractionary pressures were transmitted across the globe—producing a worldwide depression. The absence of global leadership meant that nations were on their own in developing strategies to overcome catastrophic levels of unemployment.

During World War II, precisely this diagnosis of what had gone wrong was accepted by influential intellectuals and political leaders in the United States and the United Kingdom. The United States took on the responsibility of stabilizing the global economy and such formal institutions as the IMF and the World Bank were created to assist in that process. So, for example, in the years immediately after World War II, there were again very substantial global imbalances as Europe sought to rebuild its economy,
but rather than manage these imbalances through unsustainable capital flows, the U.S. relied heavily on civilian and military aid programs.

But the very success of U.S. global leadership in the three decades after World War II generated problems. Most significantly, dramatic economic advances in Europe and Asia meant that the U.S. no longer enjoyed the industrial superiority of the earlier period; in industries such as auto, steel, and machine tools other countries were as competitive or more competitive. As a consequence, by the 1970’s and the 1980’s, the U.S. could no longer live within the institutional framework that it had earlier created.

The first step in this process was the abandonment of the Bretton Woods system of fixed exchange rates in 1973 which set in motion a dramatic expansion in global capital movements. The second step was the decision taken in 1983 for the U.S. to ignore the long-established ground rule of the global economy that nations should try to balance their international payments. Since moving towards such balance would require either a substantial retreat from the U.S. exercise of political and military power globally or painful domestic restructuring or both, U.S. leaders decided that the U.S. would simply run very large payments deficits and other nations would have no choice but to finance those deficits by lending funds to the U.S.

In a word, rather than exercise global leadership to help manage global imbalances, the U.S. simply used its dominant global position to sustain a very substantial global imbalance. Since the size of the U.S. current accounts deficit peaked at $800 billion in 2006, this meant that over several decades of rising deficits, foreigners were sending trillions of dollars into the U.S. capital markets (Krippner 2011).

These enormous flows had a number of destructive consequences. First, they helped accelerate the process of financialization in the U.S. economy; from 1983 onward, the profits earned in the financial sector of the economy rose dramatically as a percentage of overall corporate profits. Both the huge money center banks and their tiny competitors were handed enormous business opportunities by these many trillions of dollars from foreigners that had no choice but to flow into the U.S. capital market. This, in turn, accelerated a process by which the expected return on investment (ROI) for corporations that actually made things were bid up to ever higher levels. It also fueled the move to Wall Street of many talented individuals who might well have made greater economic contributions had they been employed outside the financial sector.

Second, these inflows helped fuel a series of financial bubbles including the housing and mortgage bubble that ultimately produced the crisis. In a situation where there is too much investment capital chasing too few attractive investment opportunities, there is an enormous risk of bubbles since the price of attractive assets are likely to be bid up by excessive demand. As that demand continues and winners reinvest their capital gains in the same assets, prices can rise to completely unsustainable levels.

Moreover, this dynamic happens even when foreign investors are not participating in the particular asset market that is experiencing the bubble. The point is that as foreign
capital flows in, it bids up prices and this lowers the return on the asset classes in which it invests. Other investors then pull their money from those assets because of the lower rate of return and search for new opportunities with higher rates of return. In the early stages, these shifting domestic funds are sufficient to get the bubble going.

We know that foreign funds often play a role in keeping the bubble going. Bernard Madoff, for example, reached a point where he became dependent on foreign investors to keep his Ponzi scheme afloat. Feeder funds from Europe and Latin America were critical in the final stages of the process. Similarly, European banks and other financial institutions became key purchasers of the dubious mortgage backed securities that were being aggressively marketed by the major Wall Street firms. This was one of the main routes through which the financial contraction was transmitted globally. Financial institutions around the world suddenly recognized that the allegedly AAA bonds on their balance sheets were worth far less than what the institution had initially paid. And in those months after Lehman Brothers collapsed, nobody knew whether the correct estimate was 60% or 20% of the purchase price since nobody wanted to purchase those toxic assets at any price.

In sum, it is impossible to understand the way this particular crisis played out without understanding the special role that the U.S. plays within the global political economy and the way that role empowered Wall Street firms to exploit the “exorbitant privilege” associated with the international role of the U.S. dollar (Eichengreen 2011). This means, in turn, that any post-crisis reforms will be incomplete and insufficient if they do not include measures to overcome the global imbalances.

The Global Dimension of Financial Democratization

Fortunately, the project of reforming the global financial architecture can draw on almost a century’s worth of intellectual effort dating back to Keynes’ 1919 intervention on The Economic Consequences of the Peace. More specifically, the proposal for an International Clearing Union that Keynes advanced in 1943 is still extremely relevant to the task of creating an international monetary regime that meets the three key criteria of providing sufficient global liquidity, dealing effectively with global imbalances, and providing national economies with the maximum opportunity to subordinate their economies to democratic decision making.

The core of Keynes’ idea was the creation of an international currency that would play the role that gold had played earlier. This currency “bancor” would be created as a credit on the balance sheet of an International Clearing Union and the supply of bancor could be gradually expanded to keep pace with the world economy’s rising need for liquidity. Nations that were running chronic deficits and in danger of exhausting their reserves of bancor would be required to adjust by devaluing their currency in relation to bancor. Nations that were running chronic surpluses would essentially be adding to the supply of bancor that was available to loan out to other nations. Moreover, these chronic
surplus nations would face the twin pressures of embarrassment and the fact that the additional reserves they were accumulating were earning no return (Block 1977).

Keynes’ mechanism meant that there would no longer be a need for one nation to provide the world’s key currency. All nations would be under parallel pressures to eliminate global imbalances, and this meant that contractionary policies by deficit nations would largely be offset by expansion policies pursued by surplus nations.

While Keynes’ initial design was rejected by U.S. negotiators who insisted that the dollar be the center of the post-World War II global financial system, the International Monetary Fund moved in Keynes’ direction by the creation in 1969 of Special Drawing Rights. These are, essentially additions to a nation’s quota in the International Monetary Fund that increase the supply of liquidity in the same manner as bancor. The value of the SDR is set in relation to a specific basket of global currencies. (As of 12/15/11, one dollar equaled 0.65 SDR’s.) Between 1969 and 1981, the IMF distributed 21.4 billion in SDR’s.

However, in response to the global economic crisis is 2009, the IMF agreed to add an additional 161.2 billion SDR’s to member reserves. In short, after a twenty-eight year interruption, the SDR was reactivated as a mechanism for providing global liquidity. This was a means to fight the economic contraction by bolstering each nation’s international reserves, but it can also be seen as an indication that world leaders are now contemplating a time when the United States dollar will no longer be the world’s key currency.

But even if we see the 2009 measure as an indication that Keynes’ vision is still alive, a move to a bancor system also requires that the U.S. would explicitly agree to a multi-year plan to return its current accounts to balance. Such a commitment would involve two major elements. The first would be a systematic effort to eliminate the U.S. balance of trade deficit. There has been some movement in this direction with the improvement in the U.S. trade balance for oil and natural gas, but there would also need to be a sharp improvement in the U.S. trade balance for manufactured goods. This would involve reversing the long-established pattern of outsourcing more and more industrial production to Asia and expanding U.S. exports of advanced manufactured goods. This process would be facilitated by changing current tax rules that incentivize U.S.-based firms to shift production overseas and postpone indefinitely repatriating the profits they earn. But deliberate government policies to support the modernization of the manufacturing sector are also needed.

A second prong would be a significant reduction in U.S. political and military commitments overseas. This means a more rapid winding down of the U.S. military role in Afghanistan, very substantial cuts to the network of global U.S. military bases, and significant reductions in U.S. military, security, and foreign assistance personnel stationed abroad. Since this overseas apparatus has been growing by accretion for seven decades, there is enormous room for rationalization and cost saving. Moreover, as part of
the move to a truly multilateral global financial system, the U.S. would demand of its allies in Europe and Asia that they increase their role in global security (Block 2011).

A global decision to replace the dollar with an international currency and a U.S. agreement to bring its deficit under control would also provide the opportunity to eliminate many of the other shortcomings of the current global financial and trade architecture. For one thing, the existing global institutions suffer from a severe democratic deficit and they provide insufficient power and influence to developing nations (Wade 2011). For another, the system of trade and finance rules negotiated over the last twenty years has significantly diminished the policy space that developing nations are able to use to catch up with more developed nations.

But developing a full list of necessary and desirable global reforms is beyond the mission of this particular essay. So I will limit the discussion to three key steps that follow closely from the idea of returning to Keynes’ vision of how a global exchange system should be organized:

1. Developing a global currency through the IMF also requires a return to a fixed exchange rate system. The global experiment with floating rates since 1973 has been a failure. Supporters of floating rates claimed that with markets free to determine exchange rates on a daily basis, adjustments would occur smoothly and seamlessly. This has not happened; instead exchange markets systematically overshoot on both the upside and the downside. This is hardly surprising since exchange rate traders are able to make money by betting the trend and exaggerating movements in one direction or the other.

The deeper problem is that exchange rate volatility is basically inconsistent with the predictability that economic actors require to make long term contracts. A variety of new financial instruments were invented that purported to help actors protect themselves from this volatility, but we now know that this elaborate structure of derivative instruments simply shifts risk around in ways that are unpredictable and ultimately destabilizing. Rather than build more elaborate systems of regulation to manage the risks involved in derivatives, it makes more sense to eliminate much of the need for these instruments by making exchange rates more stable.

To be sure, as Keynes envisioned, nations would have the opportunity to reset their exchange rates to overcome disequilibria, but this would involve a consultative process that would place strong pressures on nations that sought to keep their exchange rates pegged at unreasonable levels.

2. But even with a fixed exchange rate system, there will be opportunities for speculators to take large bets against particular currencies or to take massive short positions on a target nation’s government bonds. In order to discourage this type of activity, it is essential to have a global financial transaction tax that would apply to all financial instruments including derivative contracts. As proposed initially by James Tobin, the theory of the tax is to make these markets work better by assuring that investors face some transaction costs when they make large bets against a particular
currency or financial instrument. The analogy is with the operation of the gold standard in the 19th century where those who wanted to make significant bets against a particular currency faced the quite substantial transaction costs of buying gold in another country and transporting it to a place where it would earn a higher return. In short, there is a need in markets for people to engage in arbitrage when prices are not properly aligned, but overall market stability is enhanced when arbitrageurs cannot profit from small misalignments. Part of the reason that the financial transaction tax is needed is that advances in computerized trading have driven transaction costs for arbitrageurs near to zero.

3. Moving to a global currency and fixed exchange rates will solve certain problems, but it does not address the need for long-term capital to finance infrastructure, clean energy, small business, community development, and improved health and education systems. The need for such capital is particularly acute in the developing nations, but it is in short supply in rich nations as well. Ultimately, developed nations will have to figure out ways to mobilize domestic saving to finance these needs, but a new set of global mechanisms would be able to accelerate these investments in developing nations and perhaps inspire developed countries to do more.

The reality is that there are many investors around the world who would eagerly purchase long-term bonds with a guaranteed return. For example, the World Bank has since 2008 issued $2 billion worth of Green Bonds often with interest rates of 2% or 3% designed to finance climate-friendly projects. If such bonds were also made tax-free by national authorities in the way that municipal bonds enjoy tax-free status in the U.S., they would be even more attractive. Furthermore, if the expanded issuance of these bonds were linked to the creation of a Financial Transaction Tax, revenues from that tax could be used to subsidize the interest rates for loans to the least developed nations in the world. For example, funds raised by the issuance of bonds paying 3% could be reloaned at a subsidized rate of as low as 1% per year to the poorest nations. Since these nations are already paying for imported energy, the expected energy savings from green projects would provide the revenue needed to service the bonds.

The long-term goal of this international lending mechanism would be to increase the availability of capital far above the current efforts of the World Bank and the various regional development banks. Annual bond issues by the World Bank and the other regional development banks have been on the order of $80 billion per year. The goal over a period of years would be to raise this by a factor of ten to significantly expand real investment.

It is complicated to envision an institutional design for achieving such a goal while assuring that the investment flows were consistent with minimizing corruption and maximizing democratic input. Ideally, there should be a multi-level structure where each level has an interest in monitoring what goes on at both higher and lower levels and all participants—except for some fraction of ultimate borrowers—would not be seeking to make profits on the transactions.
There would be an obvious advantage in having a single peak organization that issued the bonds to establish a visible and reliable brand for investors around the world. However, there would need to be considerable democratic input at this peak level to assure that the criteria for lending did not privilege private corporations or in other ways reproduce the technocratic and anti-environmental biases that have historically been associated with the World Bank and other development agencies. This agency would then relend the money to the regional development banks that would, in turn, loan the money to organizations within countries in their regions.

THE DOMESTIC REFORM PROJECT

In parallel with the global measures, the major aim of the domestic reform agenda is to mobilize domestic savings to finance investments in the U.S. that create employment opportunities and contribute to sustainable development. This requires undoing the current situation where most household saving takes the form either of deposits at giant banks or investments with mutual funds that primarily purchase shares of the 500 largest corporations. As we have seen the giant banks recycle these funds into speculative investments and do very little to finance pressing domestic needs.

Similarly, the mutual funds do very little to finance productive investments. In the aggregate, large corporations in the U.S. are self-financing; they actually have been reducing their volume of outstanding shares through share repurchases designed to push up the stock price (Lazonick 2009). But precisely because corporate managers know that a fall in the share price endangers their control of the firm, the stock market has worked in recent years as a disciplinary mechanism that focuses firms narrowly on investments that will help the bottom line in the short term. This institutionalizes a system of very high hurdle rates—only investments that promise rapid recovery of the investment can be justified within the big corporations.

Moreover, with only a few rare exceptions, the equity markets do little to assist new firms. The option for an initial public offering is usually available only when a firm has a reliable flow of profits, so startups must find other means to finance themselves through what is often a five to ten year period before there are profits. Moreover, even venture capital firms are extremely reluctant to invest in firms that are in the early stage of technology development.

But is it actually possible to envision altering the channels through which household saving flow so that they would become available to finance currently unmet needs? Historical experience suggests a positive answer to this question. Popular distrust of Wall Street has been a recurrent theme in U.S. politics precisely because this situation has happened before—the bulk of household savings flows to Wall Street and many parts of the country are left without access to credit at reasonable rates. The agrarian populists in the 1890’s elaborated their proposal for a subtreasury system.
precisely to expand the supply of credit to farmers. When the Federal Reserve System was created in 1913, it was structured around twelve regional banks precisely to assure availability of credit on reasonable terms to every section of the country.

There have also been a series of waves of financial innovation through which new financial intermediaries emerged rather quickly (Schneiberg 2011). The most recent such period was the 1930’s when the passage of the Federal Home Loan Bank Act in 1932 opened the way for the creation of thousands of locally-based savings & loans—many of them organized as mutual savings associations. And in 1934, the passage of the Federal Credit Union Act, led to dramatic growth in the number and size of credit unions—cooperatively owned and nonprofit financial institutions.

To be sure, there is also a cyclical process through which one era’s locally-oriented financial institution evolves over time into a giant financial powerhouse that centralizes control over financial assets. The Bank of America, for example, began early in the 20th century as a grassroots rival to established banks that concentrated on providing credit to borrowers who had historically been excluded from credit. And the collapse of the Savings & Loans industry that started in the late 1980’s was the direct result of new federal rules that allowed these institutions to enter new lines of business that replaced their earlier concentration on housing finance. So in thinking about how to rebuild a structure of local financial intermediaries, it is essential to consider measures that will durably tie those institutions to community needs.

**Designing Domestic Reforms**

But in considering these design problems, it is important to emphasize one of the positive lessons of the financial crisis. We have seen that one important element of the crisis was that small financial institutions could compete head-to-head against the industry giants because of the enormous advances in information and communications technologies. Essentially, economies of scale are relatively small and can be offset by cooperation among smaller institutions. In other words, if a hedge fund with twenty employees, relying on network ties with dozens of other financial institutions can attract hundreds of billions of investments, so a local credit union, relying on similar network ties with other institutions, should be able to provide an even wider range of services to its customers than the local office of the giant bank across the street.

This is true because finance is now essentially a knowledge industry. Whether the focus is on selling complex financial instruments, trading on exchanges, or lending to actual customers, the key issue is the knowledge and skill of those who are making the actual decisions on which deals to make and which deals to avoid. And the reality is that working at a very large institution does not—in itself—make those individuals more knowledgeable and more skillful.

But this insight also points to the most serious flaw in the current organization of the financial system—the existence of a steep reward curve that makes it possible for those with the highest levels of knowledge and skill to reap rewards of more than a
billion dollar per person per year. The fact that a handful of hedge fund managers earn ten or twenty thousand more than those working at the bottom of the financial system is justified on meritocratic grounds. But there is nothing vaguely equivalent to this disparity in any other knowledge industry. On the contrary, knowledge industries tend to have more egalitarian salary structures than other industries.

The problem is that there is no correlation between skills and actual contribution to the economy. Constructing merger deals among giant firms whether the deals actually make sense or not will produce rewards in the tens or hundreds of millions of dollars, while a person who is extremely effective at providing critical financing and advice to small local firms will receive rewards only in the tens of thousands.

The logical consequence is that people migrate towards the better compensated positions, so the system overproduces certain types of knowledge and produces far too little of the types of financial knowledge that strengthen local communities. It follows that a reorganization of the financial system has to break with the premise that compensation should be commensurate to the knowledge and skill of financial sector employees.

The best way to do this is to organize the new financial infrastructure on a nonprofit basis—the organizational form that has been used by credit unions and mutual banks. The goal would be to compensate knowledge workers in this new, nonprofit financial system on a comparable scale to such other knowledge workers as teachers, professors, scientists, and engineers with increases in compensation resulting from demonstrating higher levels of skill. But nonprofit status would be a signal from the start that this is a very different career line from going to work on Wall Street; community banking would be reinvented as a public service occupation so that those whose main interest is in accumulating vast amounts of wealth would look elsewhere for employment.

Nonprofit status would also limit the logic of expansion that is extremely strong when financial institutions are organized on a profit-making basis. To be sure, nonprofit entrepreneurs still have incentives to expand the scope of their operations, but the idea would be to channel this impulse towards greater specialization. So, for example, if a particular local financial institution developed a particular expertise in financing small-scale clean energy projects, it might expand its geographical reach by using this expertise across an entire state or group of states.

As with other knowledge industries, the ideal design would involve a high degree of cooperation among networks of small nonprofit firms and agencies that would combine different types of expertise. A variety of community development initiatives already draw on this organizational model. One community organization, for example, might come up with the idea for a mixed use development that combined housing with retail stores. They would work with other organizations that would develop the plan, evaluate it, negotiate with local government, and develop a financial plan.
stage, a coalition of financial institutions would work together to raise the necessary funds.

Generating this kind of network cooperation can also be built into the organizational design because these locally-based financial entities would be plugged into a regulatory structure. Credit unions are already allowed to belong to the Federal Home Loan Bank system and their deposits are insured by the National Credit Union Share Insurance Fund. In a word, these financial intermediaries depend now—and will depend in the future—on access to credit lines and other assistance provided by federal regulators.

Given this relation of dependence, regulators could use their authority to enforce norms in favor of network cooperation and to restrain organizations that pursue aggressive expansion plans that are not rooted in actual expertise. To be sure, this requires that the government agencies would have sufficient resources to exercise real regulatory oversight.

The next step in the argument is to see how these design principles would work for organizing three distinct areas of lending and investment: lending for individuals, small business, and nonprofits, financing of larger infrastructure projects, and more substantial investments in medium-sized firms.

1. **Lending for individuals, small business, and nonprofits.**

The task of providing mortgage lending, car loans, small business loans, and financing for smaller infrastructure projects would be performed by credit unions working in cooperation with networks of small nonprofit firms that cultivate expertise in particular areas of lending such as small business and clean energy projects.

The basic skeleton for this system is already in place, but it would have to be scaled up quite dramatically. In 2010, the Federal Reserve Flow of Funds estimated that households and nonprofits held $6.4 trillion in time and saving deposits. In that year, comparable deposits in credit unions were a little more than 10% of this total or $681 billion. If this statistic were to be reversed and credit unions were to account for 90% of these deposits, the consequence would be a dramatic shift in the availability of credit for locally-based activities. Small businesses, in particular, that have historically always been credit-constrained would have much greater opportunities for growth.

Currently, however, almost all credit unions are restrained by federal law to limit their business lending to no more than 12.5% of their total assets. Typically, these are loans for limited durations with two years being the outer limit. Since a number of credit unions have already reached that level, legislation is already before the Congress to raise that ceiling to 27.5%. This legislation is strongly opposed by the commercial banks that argue that the exemption of credit unions from federal corporate taxes already provides them with an unfair advantage. But it is precisely the failure of commercial banks to provide adequate levels of small business lending that makes this shift imperative.
Since 1970, individual deposits in credit unions are protected by a federally administered system of deposit insurance. Moreover, credit unions are able to join the system of Federal Home Loan Banks that provide member institutions with lines of credit that help them manage cash squeezes in periods when interest rates suddenly spike or when they face more borrowers who are delinquent in their payments.

Even in the 1980’s when short term interest rates rose briefly to 20%, the credit union industry as a whole was able to survive the dramatic mismatch between portfolios of mortgage loans at low interest rates and much higher interest rates on deposits. 2.7% of federally insured credit unions did fail in 1981 (Wilcox 2005), but these were mostly the smallest credit unions and the rate of failure declined sharply in subsequent years. In comparison to commercial banks and savings and loans, the record of credit unions is exemplary. Their loss rates never rose above .1% whereas the loss rate for FDIC insured banks peaked at .4%.

Another benefit of reliance on credit unions as the key source of local financing is that they can be expected to be supportive of various nontraditional organizations that have historically had difficulty borrowing from banks. So, for example, other coops and B corporations-- a new type of firm that is allowed to prioritize other goals over profit maximization—should find enhanced access to short-term funding. This could easily lead to a significant expansion of activity outside of traditional for-profit firms.

But how would this shift of deposits from commercial banks to credit unions take place? The key is that it can initially be driven simply by consumer decisions to shift their money out of giant banks and into local credit unions. Campaigns to do this have already begun; Bank Transfer Day on November 5, 2011, inspired by Occupy Wall Street, was a grassroots effort to persuade consumers that they would help themselves and local communities by moving their money to credit unions.

But for this to become a real trend that drives the credit union share of deposits up to 25% of all consumer deposits over a five to eight year period and substantially higher over twenty years, requires a significant expansion of capacity within the credit union world. It would require the creation of many new branch offices in parts of the country where credit union density is low. Credit unions would also have to be more aggressive in attracting and retaining depositors and their networks would have to add many more employees with the skills to assess the risks associated with different kinds of borrowers. Finally, supportive legislation such as that expanding the ceiling on credit union loans and raising the budget for the National Credit Union Administration that regulates the industry would have to be approved by Congress.

Moreover, there is little reason to doubt that credit unions would be able to ramp up their lending as their deposit base increased. For one thing, while mortgage rates are at historic lows, large banks are still very reluctant to issue new mortgage loans. Credit unions have considerable scope to expand their mortgage lending. At the same time, as millions have retreated from bad experiences with home ownership, the demand for
rental housing has increased. There is ample scope for credit unions to respond to this demand by financing construction of new higher density rental housing.

Furthermore, there are hundreds of billions of dollars worth of clean energy projects that can pay for themselves in three to seven years. These include insulating older homes and businesses, installing energy-saving lighting fixtures, and putting solar panels on rooftops. Loans to individuals and firms to finance these projects will generate local jobs and reduce the localities dependence on energy imported from elsewhere.4

To be sure, a dramatic expansion in the size and scope of credit union lending would present some dangers. As the scale of credit union operations expanded, so also would the opportunities for fraud and corruption. But the combination of nonprofit status, embeddedness in local communities, democratic governance, and enhanced regulation should be able to limit these problems.

2. Infrastructure Projects.

Some smaller infrastructure projects such as water treatment plants or various environmental improvement efforts could be financed cooperatively by groups of credit unions that might purchase bonds issued by local authorities. But larger infrastructure projects such as new mass transit systems, new bridges or highways, high speed inter-city rail lines, rebuilding the electrical grid, and new power plants using renewable energy call for a separate financing mechanism.

The problem here is that society’s infrastructure needs have been increasing significantly faster than normal economic growth. There are two basic reasons for this. First, new infrastructure needs often do not replace older ones; they are simply layered on top of them. With transportation, air travel and highways did not replace railroads and shipping; all four systems require the upkeep of older infrastructure and the building of new. Similarly, the internet and cellular technologies have been layered on top of telephones and radio and television broadcasting.

Second, many large infrastructure projects are one-of-a-kind installations that are not able to reduce labor costs on the same scale as mass production. Building roads and bridges is now far more capital intensive than it was a generation ago, but it is still the case that the number of skilled employees required for a billion dollar project is much larger than is required for a billion dollars worth of output from an automobile or semiconductor factory. These higher labor costs mean that providing even a constant supply of new or remodeled infrastructure will require a larger share of GDP.

These rising costs of infrastructure have run directly into greater fiscal strains at all levels of government in the United States. The result has been a growing infrastructure gap where spending levels are considerably below what is needed even to maintain the existing infrastructure. As mentioned earlier, the American Society of Civil

4 The best evidence for this potential of self-financing local growth has been the growth of the social economy in Quebec (Mendell 2009).
Engineers estimated that in 2009, the nation needed $2.2 trillion of new pending to bring the existing infrastructure up to current standards.

There is broad consensus that a way has to be found to mobilize more private sector capital to finance this infrastructure investment. One path to do this is through privatization as some states have begun to do with toll roads. The private firm raises some of the costs of construction but then is allowed to collect tolls for the next 50 or 75 years. But this is a very limited solution; many types of infrastructure cannot effectively be funded through user fees. If, for example, states attempted to use this mechanism to build high speed rail links between cities, user fees would make this form of travel prohibitively expensive.

Moreover, privatization does not address two of the biggest problems with large-scale infrastructure projects. The first is that many of them are built without sufficient public debate and discussion. This can lead both to significant design failures as with some of the major Army Corps of Engineer’s projects in New Orleans or to projects that are skewed in favor of powerful interest groups. The second is that these projects routinely end up costing substantially more than initially anticipated with very large construction and engineering firms making very substantial profits. The problem is that greater resort to privatization is likely to exacerbate both of these problems.

The basic reality is that there is no real alternative to public financing of most of these infrastructure projects. If projects are chosen correctly, they will contribute to regional economic growth and that will produce tax revenues that help retire the debt that paid for the new infrastructure. This was the model that worked for thirty years when the federal government provided state and local governments with considerable assistance that helped them finance growing infrastructure bills. However, from the 1980’s onward, federal assistance has been slashed and state and local governments simply cannot afford to borrow at the scale required to finance even a significant fraction of the needed infrastructure.

The way out requires that the federal government increases its share of GDP with additional tax revenues some of which can be used to relieve the fiscal pressures on state and local governments. Either a carbon-based tax or a Value Added Tax could raise funds on the needed scale. Then it would be possible to create a Federal Infrastructure Bank with an initial capitalization of $60 to a $100 billion that would raise funds by selling bonds in the global capital markets. With such a structure, the bank could finance as much as $2 trillion in infrastructure spending over a five to seven year period.

The idea would be that some of the current federal infrastructure spending dollars such as transportation dollars would be shifted out of annual Congressional appropriations and would be funded instead through the bank. The bank would have the capacity to “insure the bonds of state and local governments…. [and] provide targeted and precise subsidies” in the form of lower interest rates on certain types of projects (Rohatyn 2009, 224).
The obvious danger of such a centralized mechanism is that it could worsen the technocratic and elitist bias of current infrastructure spending. But this danger could be overcome by building certain decentralized features into the design of how the infrastructure bank works. First, the bank’s staff would be organized on a regional basis, so they would gain greater expertise on the special circumstances of different parts of the country. Second, project applications would be initiated at the state and local level, so that even if there as a national priority placed on high speed rail, projects could not be forced on resistant regions.

Third, in addition to the well-established routine of environmental impact statements, projects would only be approved after the bank reviewed a community impact report that would examine the particular projects impact on different neighborhoods and communities and described what kinds of consultations were carried out with area residents.

The goal here would be to create a network of small nonprofit firms that developed expertise in this process of community consultation and project management. Some of these firms would be available to advise governments on how to organize the broad democratic input needed to provide legitimacy for large infrastructure projects. And a different set of firms would be available to carry out the community impact evaluations. A third set of firms would develop expertise in project auditing and oversight; they would be able to report back to both local sponsors and the infrastructure bank as to whether the project was moving on schedule.

In short, a centralized mechanism for making final financing decisions would be joined with decentralized mechanisms that are designed to generate social learning around effective infrastructure design and management. This would begin a process of the democratization of infrastructure decision-making with the possibility that in the future, cities or regions might even hold referenda in which voters choose between rival infrastructure development models.

One side benefit of the decentralized mechanism is that it would accelerate a diffusion of the expertise that now tends to be monopolized by a handful of giant global engineering firms who dominate these large infrastructure projects. As new ideas of project coordination emerge, more of these projects might be managed by medium-sized enterprises.

3. Long-term financing of small and medium-sized businesses firms.

Whether the firms we are talking about are profit-making corporations, employee cooperatives, or B corporations, there are financing needs that cannot effectively be met by 12-month or 24-month lending from banks or credit unions. For example, a recent start-up firm needs operating funds to cover the three or four year period during which it is trying to move from an idea to a marketable product. Or
another firm needs $10 million to finance a new production facility, but the expected rise in revenues is both uncertain and at least three years in the future.

These are precisely the kinds of investment that ideally should be financed with sales of stock. Those who purchase the stock know that there is more than a negligible risk that the firm will fail and the stock will become worthless. But there is also a distinct possibility that the firm will succeed and the initial investment will rise in value since it entitles the holder to a share of the firm’s future profits.

However, access to existing stock markets is currently restricted to large firms that are already generating significant revenues or can reasonably claim such revenues in the near future. Moreover, federal security laws create significant obstacles to small and medium sized firms raising money through public share offerings. The consequence is that the hundreds of billions of dollars that the public invests in mutual funds cannot be accessed by these smaller firms.

The justification for maintaining significant barriers to sale of shares by smaller firms is that this creates significant opportunities for fraud. Penny stocks—shares in public firms that sell for less than a dollar—are notoriously vulnerable to manipulation. On the one side, firms can be created simply for the purpose of extracting money from investors that is diverted into the pockets of the firms’ founders. As long as the founders effectively pretend that their firm had tried but failed, the investors have no recourse. There is also the strategy of “pump and dump” pursued by unscrupulous investors who put money into the shares of a particular penny stock and mount a campaign to persuade others that these shares are moving upwards for a good reason. When other investors jump on the bandwagon, the manipulators sell their shares at a profit and move on to another stock. Since the initial costs of the shares are so low, this type of fraud does not require very large sums of money. But since these types of fraud are commonplace, both retail and institutional investors tend to avoid the risks of purchasing equity in small and unknown firms.

The other obvious difficulty with providing equity capital for small and medium sized firms is that the risks are relatively high that these firms will fail and never pay off the shareholders’ initial investment. But this obstacle could be overcome by emulating the strategies used by venture capital funds. Venture capital funds know that most of the firms in which they invest will either fail completely or fail to provide an adequate return on the original investment. However, they also know that large gains from the minority of firms that are successful could offset those losses and produce positive returns. On the same principle, mutual funds that spread their investments across many small and medium sized firms should be able to generate decent returns from appreciation of their investment in the minority of successful firms.

But to give these mutual funds a reasonable chance of success, several other steps are necessary. First, there would need to be a screening or gate keeping mechanism to reduce the incidence of penny stock fraud. One way to do this would be to require that firms that wanted to raise money in this way should be organized as B Corporations that
would be subject to higher levels of voluntary disclosure than is required by current regulations and they would also be subject to regular review by an accreditation body to assure that they were meeting B Corporation standards. 5

These B corporations would then be allowed to sell up to 10 million shares at $1 per share on a newly created stock market for small and medium-sized firms. 6 New type of mutual fund would put together a broad portfolio of holdings from many of these firms and they would, in turn, sell those fund shares to both individual and institutional investors. 7 As firms earned profits that were distributed in the form of dividends, their share value would tend to rise. The most successful firms might decide to graduate to one of the main stock markets through an Initial Public Offering that would assure a very sizeable gain for the mutual funds that had invested at the outset.

Since these B corporations are committed to avoiding imposing costs on society through environmental degradation or bad working conditions, there would also be a justification for providing a tax benefit for those who invested in these B corporation mutual funds. For example, returns on these investments could be taxed at half the rate for other long term capital gains to help assure that this type of investment that produces broader social returns will be attractive to investors.

But even if this alternative B corporation stock market expanded dramatically, it would still not be able to fill all the financing needs of small and medium-sized enterprises. A second, parallel financial track would also be needed to expand the financing options for these enterprises. This could take the form of a convertible bond that allowed the holder to participate in future profits of the enterprise.

A firm might issue bonds of a total value of $10 million. Under the first scenario, no interest would be paid for the first five years, and then the loan would be paid back over the next fifteen years in the same way as a mortgage with interest and principle combined in annual payments to the bondholders. In the second scenario, if the firm had decided to become a publicly traded firm during those five years, it could offer the bondholders to convert the bonds into shares in the enterprise.

Here again, there would need to be trusted underwriting firms who helped the firms issue this paper and mutual funds that purchased portfolios of these instruments and resold shares to individual and institutional investors. But again the idea is that while some firms will go out of business and not be able to pay back their loans, other firms will compensate for these losses by providing above average returns to the investors. The

5 The B corporation statutes should be written in a way that allows employee cooperatives to be organized as B corporations. This would give cooperatives the opportunity to raise funds by selling shares. In the model of multi-stakeholder cooperatives, these investors would have limited rights, but cooperative members would still exercise predominant control over the enterprise.
6 These share issues would be organized to leave the firms’ initial founders in control of the company.
7 Limiting purchase of shares to accredited mutual funds would be a further step that could help insulate this market from manipulation. The mutual funds could be organized as nonprofits to assure that gains were distributed to investors.
consequence is that this mechanism would provide a stable and effective funding source that could help small and medium sized firms expand.

Conclusion

The ideas elaborated here are based on the premise that the existing corporate economy in the U.S. will steadily shrink over the next half century both as a source of employment and as a source of new capital investment. In short, trends that have marked the last thirty years can be expected to accelerate as a consequence of several dynamics:

1. Manufactured goods will continue to decline as a share of consumer purchases, and many of the services that represent an expanding share of output—health care, education, elder care, entertainment—can be effectively provided on a nonprofit basis or by smaller business entities.

2. Many types of production are becoming disaggregated with different parts of the production process controlled by smaller firms with very specific types of expertise. Up until now, final delivery to the customer has continued to be controlled by a handful of giant firms, but increasingly, small and medium-sized firms will be able to compete effectively in delivering direct to the consumer.

3. At the same time, large-scale infrastructure investments that are organized by the public sector will loom ever larger because the services that they generate—transportation, communication, information, renewable energy, and sustainable communities—will grow dramatically as a share of total consumption.

4. Currently visible trends in the area of food provision with smaller scale farms, bakeries, and local restaurants growing as a share of consumption will spread to other types of goods and services as local producers are able to take advantage of new technologies to gain new efficiencies. Regional economies will increase their rate of self-provisioning, and this will increase opportunities for noncorporate businesses of all types.

For ease of exposition, we can refer to these noncorporate businesses—small and medium sized firms, nonprofits, cooperatives, and B corporations—as the third sector after the corporate sector and the public sector—federal, state and local government.

To be sure, the growth of this third sector requires that the public sector must continue to grow because of its critical role in the provision of services such as education, health, and scientific research and its management of infrastructure projects. But in light of resistance to higher rates of taxation, this growth of the public sector would necessarily be quite gradual. In other words, the nongovernmental parts of the economy need to grow, so that they generate increasing tax revenues. But since corporate activity is likely to shrink relative to the whole economy, this requires a dynamic and growing third sector.
The domestic financial reforms proposed here are intended to enhance the dynamism of this third sector while also assuring that necessary infrastructure is provided on a timely basis. Communities that rely increasingly on renewable energy and well-functioning mass transit systems would see increasing levels of self-provisioning as local savings financed the upgrading of the housing stock, and there would be a proliferation of small enterprises and community services providing a range of different goods and services and a continuous flow of innovative new products.

In this new environment, there would be a shift in the balance of power between people and large corporations. For one thing, there would be significant contraction of the large financial institutions which would control a much smaller share of public savings. Moreover, it would be easier for government to regulate these institutions effectively because they would no longer be able to threaten to cut off vital flows of credit. Since most communities would increase their level of self-financing, they would not be vulnerable to threats that big financial institutions would stop lending.

Similarly, the greater vitality of employment creation by the third sector would also reduce the bargaining power of large corporations. The desperate competition by localities to attract investment by large corporations would be replaced by systematic initiatives to grow local economies with local resources. This would also weaken the efforts of corporations to fight environmental and other forms of regulation by raising the threat of huge job losses.

Moreover, the greater vitality of small and medium sized firms would place strong pressure on the surviving large corporations to retain employees by establishing systems of profit sharing and greater employee influence on corporate decision making. With larger corporations having less clout within the political system as well, this pressure could be reinforced by legislation that exerted pressure on bigger firms to give a variety of stakeholders a voice in corporate governance.

In sum, this project of democratizing finance could generate a strengthening of democratic governance over the entire economy. It would help to create a political context in which existing economic inequalities could be diminished while simultaneously improving the quality of life for the 99 percent.

Bibliography


