

Some reflections on the democratizing finance project following the May 1 workshop

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May, 2015

NORMATIVE FOUNDATIONS

Throughout our discussion of various institutions and processes connected to finance, we continually invoked the idea of the “misallocation” of resources/finance. Misallocation is a telling expression, for it implies some standard by which one could judge a proper allocation. The conventional economics standard is some notion of *efficiency*. In nontechnical terms, the intuition is that a misallocation of financial resources is a wasteful allocation. This specification, of course, hardly solves the problem, since it is still necessary to specify wasteful with respect to what. If one treats the objective as broadly-defined human flourishing that is fairly distributed in a population, then efficiency would suggest very different allocations than if efficiency means maximizing private returns on investments. The criterion of private returns on investments (with suitable caveats) is more or less the one adopted by those economists who adopt the market-centered principle that the optimal allocation of almost anything is the one which generates the maximum financial returns in a free market. We know all of the familiar objections to this: because there is no natural time horizon in which the idea of a return is calculated there are often deep tensions between short-run and long-run returns; externalities – both negative and positive – can break the connection between a market return and any sensible notion of real efficiency (or, equivalently, a gap between private returns and social returns); and, depending on the property rights in the funds in question, those private returns can lead to distributions of income that are grossly unequal and inefficient from the point of view of maximizing human wellbeing. Still, in spite of these objections (which, needless to say, I consider central to the critique of capitalist institutions), the simplicity of the maximal returns criterion for allocation and its practical realizability makes it attractive. The task of a finance system organized around emancipatory goals is to add other normative criteria for judging misallocation and then figure out the institutional configurations which can move us towards the optimal realization of this more heterogeneous set of values.

Elaborating a coherent account of the connection between alternative institutions and emancipatory ideals is a very challenging task. The problem is that the very idea of “the *optimal* realization of this more heterogonous set of values” is its core an ill-defined objective because once a normative space has more than one dimension we face the daunting problem of how to assign weights to the almost inevitable trade-offs across dimensions. And if there are three or four dimensions which interact because of synergies and contradictions, then the very idea of weights becomes even more problematic. This kind of complexity is one of the things that underlie the search for some singular meta-principle like justice or utility to guide our evaluation of institutions. Such a meta-principle would enable a reduction of this complexity to

a single dimension – total utility in utilitarianism, for example – or give absolute lexical priority to realizing one value before addressing others, as in some accounts of justice. Such efforts may have some important philosophical value, but in practice the different normative dimensions by which institutional arrangements can be evaluated – fairness/equality, democracy, community/solidarity, human flourishing, etc. – have at least partially independent grounding and cannot be completely collapsed into any singular principle, and thus the problem of real trade-offs is unavoidable.

So, what then should be the normative criteria by which we judge configurations of financial institutions, both to assess the degree and forms of misallocation and to propose remedies for improved allocations? We didn't really discuss this in the workshop, but the values which I articulate as generally relevant to real utopian institutional designs are human flourishing, equality, democracy, community, and sustainability, defined in the following way:

Flourishing: A good society enhances the possibilities of people realizing their potentials as broadly as possible.

Equality: In a just society all persons would have broadly equal access to the material and social means necessary to live a flourishing life.

Democracy: In a fully democratic society, all people would have broadly equal access to the necessary means to participate meaningfully in decisions about things which affect their lives.

Community/Solidarity: Community/solidarity expresses the principle that people ought to cooperate with each other not simply because what they personally get out of it, but also out of a real commitment to the wellbeing of others.

Sustainability: Future generations should have access to the social and material means to live flourishing lives at least at the same level as the present generation.

Ultimately, then, what we want is a diagnosis of the misallocation problem with respect to each of these values, and then explore how alternative institutions might facilitate a better realization of these values. There should be no expectation that improvements in terms of any one of these necessarily improve the others. Enhancing the value of democracy may or may not build solidarity and increase fairness; allocating finance to broadly improve human flourishing may or may not enhance solidarity and community; and so on. In general I have focused mostly on equality and democracy, but this is mainly because the institutional implications of these values tends to be clearer.

TWO DOMAINS OF FINANCE

Another theme which animated much of our discussion was the distinction between what might be thought of as two domains of finance: Allocations of already accumulated funds vs allocation of funds that are created by the very act of allocation. Finance is all about allocating financial resources to be used for various purposes. Some of these already exist as accumulated

funds held privately (savings) or publically (tax revenues); some of these are created in the process of allocation (credit/loans by banks and shadow banks).

One of the allocation issues is the relative weight and articulation of these two kinds of allocation processes. Mostly our discussion focused on the credit issue, I think mainly because it was so implicated in the 2008 crisis but also because new credit institutions seem like they could open up emancipatory possibility more effectively than new investment institutions: credit institutions could be tailored to increase the flow of resources towards any priority, and because such institutions create the funds “out of thin air”, credit creation seems less constrained by the priorities of people who already control wealth. Nevertheless, since direct government investment (via tax revenues) and government grants (and not just loans) are part of a finance system, the idea of democratizing finance should ultimately include the direct role of government financing of projects, not just its role in setting priorities for credit creation.

FOUR MISALLOCATION PROBLEMS

There are four interconnected problems of misallocation of financial flows that we touched on in one way or another in the course of the workshop:

Problem 1. Destabilizing/crisis-inducing allocation vs stabilizing allocation

A central preoccupation of much writing on finance since 2008 has been the problem of crisis-inducing misallocations. This is implicit in Fred Block’s elaboration of Polanyi’s idea of the self-destructive dynamics of the under-regulated market, especially in the case of fictitious commodities like money. *Self-destruction* is not the same as *harmful to people* in terms of values such as flourishing. Rather, self-destruction implies that financial markets will generate serious instability and crisis if not properly embedded in regulatory processes: badly regulated financial markets destroy their own conditions of existence. The problem of instability and crisis is also central to Bob Hockett’s account of the recursive collective action problems of a finance system once the real control over credit creation shifts from the state to financiers (which he refers to as financialization). The destructive dynamic here, according to Bob’s analysis, is set in motion when the central target of finance shifts from organizing flows of resources to the real economy to the speculative chase for returns in the secondary market for financial assets.

In terms of the real utopia problem of envisioning a democratic-egalitarian finance system, financial stability is clearly an important background condition. While it is probably too simple to argue that the ideal finance system completely eliminates all speculative activity, the consensus in the discussion was clearly that speculative investment should be vigorously contained and certainly not be the driver of the whole financial system.

One of the things that needs to be clarified further is precisely what positive functions are served by the secondary-market in financial assets since such investing in the secondary market does not by itself direct money into the real economy, into real projects that provide goods and services to meet needs, etc. One argument in defense of secondary markets which we discussed is the idea that home loan mortgage originators can issue more loans for financing homes if they can “clear the books” by selling the loans on the secondary market via

mortgage backed securities. Given the constraints on the amount of credit they can issue because of regulatory capitalization requirements, a loan originator will be able to issue more loans – i.e. create more credit for the real economy project of home building and homeownership – if there is a secondary market in MBSs. In a private capital financing system, this does provide an argument for the speculative market. But are there other ways of accomplishing this that does not have the side effect of cultivating a speculative orientation to finance? In the absence of profitable investment opportunities in the real economy – which some people like Arrighi argue is a general state of affairs in the current era – is there really a way of blocking the persistent development of new ways of engaging in speculative investment? From an economic point of view – not a political point of view, but an economic one – would there be a difference if the state taxed the wealth holders who would otherwise buy MBSs and then used that tax revenue to underwrite a greater volume of mortgage loans?

Problem 2. Misallocation between public purposes and private purposes

A second kind of misallocation problem concerns the relative weight of public concerns within the finance system. The simplest idea of public concern is the full-fledged “public goods” problem – non-rivalrous and nonexcludable goods and services. Everyone agrees that pure public goods will not be provided efficiently by markets (or even not provided at all), and so direct government action is needed. If the public good involves large capital outlays, then paying for it through borrowing rather than direct spending also makes sense.

The idea of public priority or public concern, however, extends well beyond this narrow idea of pure public goods. One can speak of the public-goods aspects of various kinds of projects. This includes lots of public amenities which serves public purposes even if it is not strictly non-rivalrous and non-excludable. One definition I saw on line was simply: “a commodity or service that is provided without profit to all members of a society, either by the government or a private individual or organization.” Even more broadly one could talk about positive externalities as a kind of public good. In any case the misallocation problem is that existing systems of finance – both of direct investment mechanisms and credit mechanisms – provide insufficient resources for these kinds of projects.

One of the places where we discussed this issue was in the proposals for some kind of public infrastructure investment bank or for an institution that would attract private capital for public infrastructure projects. One thing that was not quite clear here was why the best real utopian solution to the problem of funding public goods infrastructure was attracting private savings rather than simply government funding through direct payment and government debt. It is clear why there might be *political* reasons to organize the system in such a way that it harnesses private investment -- perhaps, in conjunction with mechanisms that block speculative investment, this could be a politically effective way of absorbing part of the capital glut of savings by the wealthy. But it wasn't so clear why -- aside from political considerations -- it would be preferable in principle to mobilize private savings for public purposes rather than simply to tax people to create public resources available for such public purposes.

Problem 3. Misallocations among private projects

Much of the discussion involved credit market failures in allocating resources across possible private projects. This was one of the issues, for example, in the discussion of Fred's analysis of the decline of community banks and other forms of locally embedded credit institutions. Big national consolidated banks have little interest in cultivating the staff expertise and local knowledge/information needed to fund many local projects. Algorithmic procedures for assessing loan applications will of necessity miss many reasonable local projects.

There was also discussion in this regard as to whether p2p lending platforms and other forms of crowd-funding would be an improvement in this regard. Mostly there was skepticism that p2p lending would be able to effectively function like banks, creating credit in the process of connecting lenders to borrowers. Crowdfunding might be able to provide a vehicle for direct investment with less intermediation than banks and with more openness than private equity or venture capital firms, but it was much less clear that they would be able to solve the information problems needed to function like real credit-creating institutions.

Other issues in the misallocation of financial resources across private project include:

- Fred's discussion of the "valley of death" in the development of small businesses that are connected to some technological innovation, where it is very difficult to get credit to sustain projects during the stage between initial development of a technology and successful production and marketing.
- Misallocations of credit to projects proposed by historically disadvantaged categories of people because of race, ethnicity, gender, etc. This is especially a problem because of the lack of collateral for historically wealth-deprived communities, but even apart from this, undoubtedly discrimination occurs. The solutions here seem pretty much consistent with a well-functioning capitalism: anti-discrimination rules combined with some kind of affirmative action procedures to deal with the transition from a world of historic discrimination.
- Credit scarcity for cooperatives and other less conventional forms of enterprise. This might require more specialized credit-creating institutions designed for such projects. A case can be made that more democratic firms with stronger rootedness in a region by virtue of employee ownership should be treated as a public good insofar as a regional economy with many such firms will be less vulnerable to capital flight, more able to reduce negative externalities, etc. If this is right, then this provides a justification either for specialized credit institutions that provide below-market interest rates, or various kinds of programs where public grants are matched with private loans as a way of channeling finance to such firms. (I am disposed to capital grants more than subsidized interest because a direct capital grant symbolizes the public paying for the positive externality in a more explicit way, but I don't know the arguments for and against this form of transfer over the subsidized credit form).
- Inequality-enhancing misallocations of private finance. In addition to the destabilizing effects of financialization discussed above, the misallocation of finance to speculative purposes exacerbates inequalities.

- Nonrecognition of externalities of private investment. Credit institutions have no real way of incorporating into their credit allocation processes for private projects the distribution of positive and negative externalities across projects. Socially-screened investment funds do this for various kinds of investments out of household savings because of the willingness of some investors to accept lower rates of return to express their values, but this generates quite weak effects. Tax subsidies to capitalist firms that “promise” to create jobs also implies a recognition of a public goods aspect of investment, but since there are generally no strong sanctions for failing to deliver and since different jurisdictions compete for those investments with a race-to-the-bottom on tax breaks, this is a pretty limited way of actually directing finance towards positive-externality generating investments.
- The succession problem for successful Baby-boomer SMEs. An interesting set of issues was raised (in a discussion outside of the workshop itself) concerning the absence of adequate mechanisms for channeling finance for the conversion of privately owned small and medium enterprises to various forms of worker ownership – ESOPs, cooperatives, hybrids, etc. Baby-boom owners are ready to retire and when they lack family members to take over, they do not have fully adequate mechanisms for financing worker buy-outs. The creation of specialized credit institutions for this purpose could be useful for shifting the broad ownership structure of the economy over time. The law providing for ESOPs does create mechanisms for this, but to accelerate this process perhaps stronger mechanisms are needed.

Problem 4. Misallocation among public goods projects

There was less discussion of this issue than of the other problems above. One place where this was raised concerned the relationship between local public goods investments and more macro-levels of financial allocation, and the difficulty in creating an effective nested credit-creating system for this. This is not as straightforward as the “Hayekian” information problem for private investment, where one can count on private investors scrutinizing alternative projects for risk and profitability because they have “skin in the game” and are seeking private financial returns. This rationale for decentralized private banks providing loans doesn’t really work for allocations across public projects, whether the financing is coming from the state directly or through some mechanism of mobilizing private capital for public purposes. The only Hayekian information problem would be the identification of default-possibilities among public bond issuers, but not really the probability of success for the public infrastructure, public goods projects themselves (except in the very limited cases where such projects also directly generate an income stream – e.g. tolls roads – which could become the basis for a return on investment aside from the bonds themselves). Fundamentally, then, the problem of normatively optimal allocations across public projects becomes a problem of democratic decision-making and priority setting and how democratic deficits can be overcome. In some contexts something like participatory budgeting can contribute to the required form of deepening democracy.

STRATEGIES FOR THINKING ABOUT INSTITUTIONAL INNOVATIONS/ALTERNATIVES

Franchisor/Franchisee credit creation

The framework of analysis of banks elaborated in Bob Hockett's paper could be a basis for discussing the array of new institutions that are needed. Hockett describes the process this way: The relationship between the Federal Reserve Bank and private banks should be seen as a relationship between a franchisor and franchisee. The Franchisor – the Fed – deploys a public resource that is collectively owned by everyone in the society: the full faith and credit of the United States. This is a public good produced by the long-term tax capacity of the government, given the stability of the state and the robustness of the economy. What this stability means is that the expectation of future resources can be called upon to create credit in the present to be allocated for various purposes. The Franchisor could simply create this money and either give it out to people in grants or rent it out to people in loans. But the Fed is a centralized institution and is likely to make all sorts of mistakes in both grants and loans if it takes direct responsibility for picking projects. So, it certifies franchisees to do this on its behalf. The franchisees – banks – are required to have a certain amount of capital and meet other criteria, but once certified they are allowed to use their judgment about where to extend credit up to some limit specified by the regulatory regime. They are allowed to do this because it is assumed that their private incentives and capacities provide the necessary Hayekian conditions for reasonable allocations of the public resource. For this “public service” they are allowed to make a profit through fees, interest payments, etc. When they extend credit they create money. This is all explained in some detail in the paper.

In the existing financial system the main franchisor is the Fed and the main franchisees are private banks, with “shadow banks” having the character of poorly regulated unofficial franchisees. One way of thinking about the design of alternative institutions is to create a number of specialized new franchisors and an array of new kinds of franchisees, each designed to solve some problem of misallocation. We did not discuss this in sufficient detail for the menu to be clear to me or the rationale for different possible configurations. For example, I am not sure what would be the virtue of an array of more specialized franchisors as opposed to a more general purpose franchisor and more specialized franchisees. In any case, a partial list of the sorts of things we discussed would include:

Franchisors

- The Fed for broad spectrum lending by private banks
- a franchisor specialized in home loans
- a franchisor specialized in credit for SME conversions to employee-owned firms
- a franchisor specialized in infrastructure

Franchisees:

- For-profit banks
- various forms of non-profit banks: credit unions, cooperative banks, municipal banks
- Local public bodies
- Nonprofit community stakeholder organizations

Regulation versus agents of allocation

Another dimension for thinking about alternatives to the existing system is the distinction between regulations of institutions and the creation of new Institutional agents of allocation. There has been a great deal of discussion of regulatory reform in the aftermath of the 2008 financial crisis, and much of the work of dampening of volatility and crisis proneness can probably be achieved by better regulations. New regulations may require new regulatory bodies – new agencies for monitoring and sanctioning – but this is still different from creating new institutions for actually allocating accumulated funds and creating loans. My intuition is that the main burden of a real utopian finance system revolves around creating the new institutional agents, new bodies with mandates to allocate finance in new ways. “Democratizing finance” involves figuring out what should be the configuration of such institutions and how their priorities can be democratically accountable.

One rough cut on these issues is that the new regulatory rules and processes will be largely top-down and centralized while the new institutional agents for democratic-egalitarian allocation need to be bottom up and decentralized. This is an intuition only, but it might be worth exploring the idea that there is a general correspondence here.

A general typology of agents and allocations

One way of approaching these issues would be to fill out a typology of some sort of the world as it is and the world as it could be. The first provides the basis for the diagnosis of problems; the second the general map of real utopian solutions. Here is a blank template for this:

Agents of finance allocation

		<i>Private: for-profit banks and investment houses</i>	<i>State</i>	<i>Social entities: private nonprofit; community</i>
Type of finance to be allocated	<i>Dispersible Funds: Loans</i>			
	<i>Dispersible Funds: Grants</i>			
	<i>Dispersible Funds: direct spending on Projects</i>			
	<i>Creatable Funds</i>			

More columns and rows could be added to this, but something like this could help give clarity to the real utopian alternatives.

Existing Institutions, Transitional forms, destinations

One final issue for the exploration of alternatives concerns the problem of transitional forms. Part of the idea of real utopias is to bring into relief the connection between an ameliorative reform of the existing world and the creation of an optimal configuration of institutions and structures. Some ameliorative forms have the character of putting into place aspects of the ideal world we want – parts of institutions, partial realization of institutions, small scale versions of larger institutions, enclave versions of more general proposals, etc. One can say in such instances that the reform prefigures the emancipatory alternative. This is what I like to call “real utopian alternatives”. Other ameliorative reforms are not themselves constituent elements of an emancipatory alternative, but nevertheless may help pave the way for such alternatives. They may remove obstacles or stimulate virtuous dynamics, even if, in the end, they would themselves be eliminated if progress were made towards emancipatory goals. Many types of affirmative action are like this: they improve things in the world as it is and open up space for future egalitarian developments, but they are not themselves building blocks of an egalitarian democratic alternative. And still other ameliorative reforms could actually constitute obstacles to more advanced transformations. They just solve a current problem, but could undermine more egalitarian options. Maternal leave programs that exclude fathers can reinforce the gender division of labor and gender inequality.

In thinking about a reconstructed finance system I think we should be attentive to this. Some of the reforms we have discussed have the character of more perfectly realizing strictly capitalist objectives. Creating rules that prevent excessive risk-taking on overly leveraged investments in secondary financial asset markets might be an example. This might be a good thing, and make for a better functioning capitalism, but in and of itself it is less clear that it moves in the direction of a more democratic egalitarian system of finance. Which new institutions in a reconstructed financial system really are building blocks for a deeply democratic egalitarian economy?