

Democracy, Law and Global Finance

Reorganizing finance for Inclusive growth

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Introduction

This project addresses the role that finance does, can, and should play in the organization of socially inclusive economic growth. It does so by focusing on the institutional arrangements, expressed in the details of law, that can more effectively enlist national and international finance in the service of production and that can do so on a broad base -- a base benefiting directly a major part of the economically active labor force and benefiting them as producers, not simply as consumers. It does so, as well, by asking how the quality of democratic governance and the level of democratic participation in an economy influence the extent to which finance does or can perform this mission. Thus, the focus of the project devolves, on one side, into an inquiry into the service that finance does, can, or should render to small and medium-size businesses. In every contemporary economy, such firms account for the decisive preponderance of output and for the overwhelming majority of jobs. The focus falls, on the other side, into the ways in which "deficits" of democracy suppress the productivist potential of finance. The key connection studied in the project is the relation between the democratic context and the productive uses of finance in contemporary economies.

The intentions of the project are both positive and programmatic. They are positive insofar as they seek to explore the considerable range of institutional variations that already exist among contemporary economies in the extent to which the connections among finance and the real economy are either tightened or loosened. They are programmatic insofar as we take this existing range of variation as a basis for new variation. We view the present differences among today's economies with respect to the issues that we explore as a subset of a much larger range of possible institutional innovation. Within that larger range, we seize on those institutional innovations regarding the organization of finance and its relation to the real economy that promise to be especially useful to the advancement of the most widely professed policy goal in the world today: the organization of socially inclusive economic growth.

A major bridge between the positive and the programmatic aims of the project is the identification of a legal-institutional toolkit: a series of institutional innovations in legal form, informed and inspired by contemporary experience, that are likely to be beneficial, in different combinations, to the organization of socially inclusive growth, and to transparency and accountability in the formulation of economic policy and financial legislation.

Themes of the project

Three large themes are central to our project.

1. Finance and democracy. The recent worldwide financial and economic crisis has deepened and sharpened discussion of the relation of finance to democracy. Much of the academic and policy debate, however, has focused on the negative and narrow matter of capture: the extent to which financial interests influence, to their advantage and to the detriment of broader social goals, the course of public policy.

This purely negative perspective is important, but insufficient. For us, the question of democratic accountability in finance can be translated into the question of the extent to which finance is led, or made to

serve the real economy, rather to serve itself, and to do so across a broad base of productive agents and opportunities.

Democratic governance in the economy may also be given a larger meaning. Among the components of this meaning are:

- a. The establishment of governmental entities capable not only of monitoring but also of mastering financial interests. (Example: Iceland today, one of the most vigorous democracies in Europe, has been, in the aftermath of the crisis, one of the only countries that has stood up to the interests of high finance. The United States in the 1930s and Sweden in the 1990s offer similar examples of democracies that refused to privilege creditors over their own citizens.)
- b. Transparency and accountability in the formulation of economic policy and financial legislation. A commitment to transparency and accountability means not allowing the substance of policies that can affect the lives of millions of people to be disguised behind legal and economic technocracy. It means clarity about the interests being benefited and prejudiced by every major governmental decision. (Example: the bailouts orchestrated by the Bush and Obama administrations in the United States could not have taken the form, or achieved the dimension that they did, had the distribution of cost and benefit been more transparent to the country and the key decisions less concealed behind a veneer of economic necessity.)
- c. Vigorous participation in public life, sustained by reforms of electoral regimes, of campaign finance, and of free access to the means of mass communication. (In all contemporary democracies, a close relation exists between the level of civic engagement in politics and the facility with which the state is captured by the interests of high finance, to the detriment of a broader array of popular and productivist interests. Example: the contrast of the United States in the 1930s to the United States today.)

2. Finance and the real economy. Understood in this fashion, the question of finance and democracy leads directly into the question of the greater or lesser services that finance renders to the funding of both established and emergent productive activity. The premise is that institutions, expressed as law, matter: that they can either tighten or loosen the relation of finance to the real economy.

3. Finance as a protagonist in the organization of socially inclusive economic growth. Just as finance can serve the real economy to a greater or lesser extent, so too in serving the real economy, it can do so in ways that have a narrower or broader range of firms as their addressees.

This abstract formulation in turns leads into more tangible and focused questions about the extent to which financial sophistication has been, and can be, put at the service of the small and medium size businesses that are, by any measure, the most important agents in contemporary economies.

Crucial questions

These themes generate a number of empirical questions that serve as focal points for the positive or explanatory part of our project. Among these sets of crucial, focused questions are the following:

1. A vast amount of empirical research has demonstrated that in all contemporary economies production is largely self-financed on the basis of the retained and reinvested earnings of private firms. Most financial activity has only an oblique or episodic relation to the financing of production. Yet contemporary economies do differ in what one might call financial deepening: the enlistment of finance in the funding of established or emergent production. Similarly, they vary in the success with which they channel long-term saving into long-term productive investment. What can one learn from these existing variations for the design of new policies and institutional innovations useful to financial deepening and to socially inclusive growth?
2. The financial activities enjoying the clearest and most proximate relation to broad-based financial deepening, such as venture capital, represent a tiny part of finance even in those countries, notably the United States, in which venture capital is most established. How could the functions of these patently important but relatively small parts of finance come to be performed on a much larger scale, to the benefit of a much larger range of economic agents, and by means of a broader array of institutional vehicles (other than traditional venture capital and private equity)?
3. The governments of all major countries have entities, and some times even ministries, designed to support both established and emergent forms of small and medium-sized business. Yet the record of policy innovation in the support, including the financial support, of small and medium-sized business seems vastly inadequate, in both conception and effect, to this task.

The problem gains significance in the light of the emergence of new styles of production, often called “post-Fordist” (by allusion to Fordist mass production). Most small and medium-size firms, even in the most advanced economies, in services as well as in manufacturing, remain caught in pre-Fordist rearguards of backward-looking practice and rudimentary technology. How could they be brought to a post-Fordist vanguard of advanced, flexible organization, without having to achieve a large scale of production or to pass through an intermediate stage of belated Fordist mass production? And what role could finance, once reorganized, perform in such initiatives?

4. Many emerging or middle-income countries around the world have experimented successfully with national development banks. However, although these banks frequently establish programs addressed to the needs of small and medium-size firms, they have rarely succeeded in devoting a major part of their funds and efforts to such firms, even when they have made good-faith attempts to do so. What can be learned from comparative experience about what is missing?
5. The character of democratic governance and the level of democratic participation seem to be closely related to the ability of the state to make finance serve broader social interests rather than allowing it to influence to its advantage the course of policy. What does contemporary experience teach us about the relation between failures of democratic governance or restraints on democratic participation and the failure of finance to perform more fully its productive mission in contemporary market economies? What can we

learn from past and present variations in the design of political institutions, the severity of the “democratic deficit,” and the practice of economic policy that suggests alternatives to the present reign of independent central bankers and ministerial technocrats beholden to the interests and preconceptions of high finance? Under what conditions and arrangements can more democracy, with respect to finance, come to favor broad-based financial deepening, not just restraints on the earnings of financiers or the repression of speculative financial activity?

It is clear that each of these sets of questions has a programmatic horizon relating them to our major themes.

Country theaters of the project

We intend to develop this project in the context of a small but important number of rich and developing economies, especially: the United States, Germany, Sweden, India, and Brazil. Comparative experience in these five economies holds a vast store of answers to our questions.

Theoretical perspective

A word about the theoretical perspective from which we conceive this project must here suffice.

Much contemporary discussion of finance presupposes the idea, natural to neo-classical economics, that markets, including capital markets, suffer only localized failures: for examples, failures of competition or asymmetries of information. The response to a localized market failure is a localized regulatory intervention. From this conception, there arises the notion that if there is trouble with finance, the solution must be simply more or different regulation of finance.

Our perspective is entirely different. Markets, including financial markets, can be organized in systematically different ways. Institutional arrangements can tighten or loosen the relation of finance to the real economy. Finance can indeed be made better to serve the real economy rather than being allowed to serve itself. It can be made to serve the real economy in ways that are either more inclusive or more exclusive. Existing institutional variations, revealed through comparative study, can represent guideposts to larger possible institutional variations.

Further development, contextualization and support for this perspective may be found in the discussion and references included in Appendices I and in the writings of the PI and senior collaborators included in the CVs included in our Stage 1 submission.

The role of legal analysis

This theoretical perspective justifies an important and unfamiliar role for comparative legal-analysis.

Economists often think of law in purely technical-instrumental fashion: policy, driven by interest and ideology and informed by economics, is drafted as law. In fact, law has to do with the detailed institutional life of a society and an economy: its institutional arrangements represented in relation to the conceptions that make sense of them. The established and possible institutional variations that form the object of our inquiry exist as law. The institutional toolkit that we seek to define is a repertory of legal devices. Legal thought thus becomes, together with political economy, the discipline most pertinent to our proposal.

Appendix I

The distinctive character of the structural perspective informing this research initiative

The distinctive character of our perspective is best understood by comparison to a number of influential tendencies in present-day thinking about the problems of law and finance. We have described in other work the inadequacy of the two leading theoretical traditions: neoclassical and Keynesian economics. From the standpoint of this project, these traditions share a common deficiency. Each is deficient in institutional understanding and imagination. Neither can embrace the idea that there can be alternative ways of organizing the relation between finance and the real economy, as an initial step toward reorganizing the market economy as a whole.

The distinctive character of this perspective may be further illuminated by comparison to four inadequate approaches to the understanding of structure:

1. Naïve legal constructivism. Market economies are constituted by legal arrangements, as legal thought has demonstrated with increasing clarity over the past one hundred years. There is a pre-set list of basic types of social organization, each with a natural or pre-set legal content. The task of law is to fill in the outline – to translate the logic of the type(s) into legal and institutional detail.

Naïve legal constructivism trivializes the significance of law and legal thought to the understanding, imagination and creation of structure and structural change. Law is the medium in which novelty is established, most commonly through analogical extension or recombination of past and present institutional variations. These variations matter. Alternative ways of organizing “capitalist” or market economies influence every aspect of economic life, including the basic arrangements of production and exchange. They shape how an economy grows and works. The organization of finance and of its relation to the real economy is one aspect, among many, of this larger reality.

2. Structures and systems theories. There is a striking affinity between the way that institutional structure and structural alternatives are approached in mainstream conservative political-economy thinking and in the tradition of Marxist social theory. All these tendencies locate the relevant framework or structure in an abstraction such as capitalism or the market economy. According to this way of thinking, the abstract type or structure recurs in history in many different circumstances. It has an in-built legal and institutional content, which may become apparent little by little. Although it may vary, it is indivisible; all its parts stand and fall together. It evolves in stages and obeys certain laws of change and operation.

Our working assumption is that the relevant legal-institutional structure needs to be depicted at a much greater level of detail or concreteness. At this level, it ceases to appear as a recurrent and indivisible type, which conforms to certain laws of change and has a preset institutional content.

A structure, in the sense illustrated in my argument, can exert a decisive influence and be recalcitrant to change and nevertheless represent a hodgepodge, capable of being explained only in the light of its particular history, full of accident and suppressed transformative opportunity.

3. **Vulgar Weberism.** A common response to the deficiencies of established ways of thinking in comparative law and political economy is to expand the scope of analysis by insisting on the importance of history, culture, and politics, without, however, relying on any particular conception of structure or of its reformation. Call this tendency vulgar Weberism; one of its sources of inspiration is the economic and legal sociology of Max Weber. By failing to articulate a different vision of structure and structural change, it fails to mount a real challenge to the ideas with which it is often contrasted. Expanding the conversation is not enough; we need to change it.

4. **Alternative capitalisms.** A long tradition of writing in comparative political economy explores differences in the way that the contemporary market economies and their financial systems are organized. This literature goes in the direction for which I argue. However, it stops short because it almost invariably supposes that there is a basic paradigm, of capitalism or of the market economy, of which contemporary economies ring changes.

On the view developed here, past and present variations in the organization of finance and of its relation to the real economy represent a subset of a broader universe of institutional possibilities. There is no predetermined limit to how far these differences can go. We can envisage points of departures, directions, and next steps. However, we cannot legitimately mark out a circumscribed horizon of institutional possibilities.