



Financial Structures and Egalitarian Economic Policy

Robert Pollin

December 1995

**POLITICAL ECONOMY
RESEARCH INSTITUTE**

Gordon Hall
418 North Pleasant Street
Amherst, MA 01002

Phone: 413.545.6355
Fax: 413.577.0261
peri@econs.umass.edu
www.peri.umass.edu

WORKINGPAPER SERIES

Number 182



Financial Structures and Egalitarian Economic Policy

I. Introduction

In various incarnations, egalitarianism has been a fundamental concern of economic policy for most of the twentieth century.¹ The egalitarian impulse—and its corollary, opposition to the stark inequalities of free market capitalism—was embodied in both Soviet-style socialism and social-democratic Keynesianism as they developed, primarily in the first quarter-century after the end of World War II. Both models achieved major successes in a range of countries, especially through the 1960s. Countries with Soviet-type economies attained high growth rates and the majority of people living in them enjoyed rising living standards, including income, job, health and housing security. The social-democratic/Keynesian approach also succeeded in reducing inequality, increasing security, as well as contributing to the dampening of the capitalist business cycle.²

However, both models also contained several basic contradictions. Among the most evident were the dictatorial political foundations of the Soviet

model and its related incapacity to shift from an initial phase of large-scale industrialization to one based on innovations in production processes and product designs. For its part, the Keynesian model has been unable to reverse the trends of declining growth and increased mass unemployment in advanced economies. The Soviet model has completely collapsed under the weight of such contradictions and social-democratic Keynesianism has been in eclipse since the 1970s.³ Neither model now offers a viable basis for a renewed egalitarian project.

Progressive political movements have been weakened by the absence of coherent egalitarian economic programmes. In this absence, progressive movements are unable to specify a broad-based policy agenda they support. Such a lacuna is especially damaging given that support for the Left has again begun to grow, as the full implications of Reaganism, Thatcherism, IMF/World Bank structural adjustment programmes and Eastern European free-market shock therapy are no longer matters of speculation.

This paper pursues a new approach to egalitarian economic policy. It is concerned with methods of bringing dramatic increases in the democratic control over financial markets and the allocation of credit, without sacrificing the basic sources of micro efficiency and macro coordination and stability that are necessary for any viable economic strategy. The focus here on financial issues is not meant to suggest that there is less need for comparable policy measures in other economic spheres, in particular the labour market and related institutions. Nevertheless, the premise of this paper is that policies focused on financial institutions and activities must be a central feature of any renewed egalitarian policy project.

There are several reasons why this is so. To begin with, it has been clear for some time that even the most mildly progressive governments face formidable opposition to their programmes from powerful interests within financial markets. Some well-known examples of this recurring phenomenon include the Labour governments in Britain in the 1930s, 1960s and 1970s, the Mitterand government in France in the 1980s, and,

¹ I wish to thank the following people for their stimulating comments on this work: Philip Arestis, Dean Baker, Fred Block, Bob Brenner, Jerry Epstein, Andrew Glyn, Ilene Grabel, John Grahl, Marty Hart-Landsberg, Michael Howard, Makoto Itoh, John King, seminar participants at the Universities of Vermont, Cambridge, and California-Riverside, and participants at the September 1994 conference on 'Demand Rehabilitation: Finance, Trade and Technology', sponsored by Pantheon Sorbonne Paris 1 and SOAS, University of London. I am also grateful for my graduate students at UC-Riverside for moving with me into this topic. A shorter version is being published by *International Papers in Political Economy*.

² Some standard evidence on these indicators is summarized in Robert Pollin and Alexander Cockburn, 'Capitalism and its Spectres: The World, the Free Market and the Left', *The Nation*, 21 February 1991, pp. 224–36.

³ See Perry Anderson and Patrick Camiller, eds, *Mapping the West European Left*, London, Verso 1994, and Andrew Glyn, 'Social Democracy and Full Employment', *NLR*, no. 211, pp. 33–55 for a range of perspectives on the condition of West European social democracy.

most recently, the Clinton Presidency in the US.⁴ Third World governments regularly confront even stronger pressures, especially since the 1980s, as the IMF and World Bank have imposed deflationary structural adjustment programmes on terms established by the international financial community.

But even assuming that such political forces could be neutralized, the tendency of financial markets toward speculation and instability have also weakened the capacity of governments to successfully implement egalitarian macroeconomic policies. The primary instruments for conducting macro policy—deficit spending and central bank monetary interventions—are both financial mechanisms, and thus their ability to operate effectively depends on how well policy initiatives can be transmitted through the financial system. Financial market instability has increased substantially since the early 1970s relative to the first phase of the postwar period, including such period-defining events as the collapse of the Bretton Woods system in the early 1970s, the Latin American debt crisis in the early 1980s, and the merger and takeover wave in the US and UK in the latter part of the 1980s. This rise of financial instability has weakened the transmission mechanism from policy instruments to policy targets.

Given these considerations, it follows that egalitarian movements will have to confront financial market pressures through explicit programmatic measures. Yet, in contrast to the situation with labour-market issues, the Left has for the most part failed to even consider seriously the types of policies that might be effective in addressing both the political and structural problems deriving from financial markets. There are also more positive reasons for egalitarians to pay attention to policies focused on the financial system. Finance is the conduit for all economic activity in market economies. Because nothing happens unless it is financed, exerting control over the financial system is an efficient way to influence the widest possible range of activity with a set of relatively modest and simple policy tools.

Moreover, many researchers have now observed that there are considerable differences in the financial systems operating within the various capitalist economies. What has emerged from this research is that some financial systems—in particular what are often called the ‘bank-based’ systems—have been more successful than others—the ‘capital market-based’ systems—in promoting long-term growth and financial stability. The basis for the success of the bank-based systems is their reliance on non-market arrangements in organizing financial institutions. These non-market arrangements continue to operate, moreover, despite the wave of financial market globalization and liberalization that has been gaining

⁴ The Clinton administration’s abdication before financial market pressures is chronicled in great detail in Bob Woodward, *The Agenda*, New York 1994. Woodward portrays both Clinton and the relatively progressive members of his administration as truly stunned by the power of financial markets to override his electoral mandate. Clinton, for example, at one point declares, ‘You mean to tell me that the success of the program and my reelection hinges on the Federal Reserve and a bunch of fucking bond traders?’ (p. 84). He later concludes, ‘Here we help the bond market and we hurt the people who voted us in.’ (p. 91.)

momentum at least since the collapse of Bretton Woods. While these bank-based systems have not been constructed to advance egalitarian aims, the principle argument of the paper is that they can be successfully adapted for that purpose once their central operating mechanisms are understood and appropriately redeployed.

Following this introduction, the paper is organized into three main sections. Section two surveys the literature on bank-based and capital-market based financial systems. In general, this literature finds that bank-based systems, such as those in Japan, France, Germany and South Korea have been more successful than capital market-based systems, such as those as in the US and UK, in solving the incentive, coordination and informational problems inherent in capitalist economies, and indeed in all complex economic systems. Because of this, bank-based systems are better equipped to promote longer time horizons and a stable financial environment. Their structures also create more favourable conditions for activist government policy interventions, including both traditional macro policies and public credit allocation policies. At the same time, the bank-based systems generally operate through highly undemocratic public and private bureaucracies, which are clearly inimical to any egalitarian policy project. The challenge, then, is to develop policy approaches which can combine the efficiency-promoting aspects of bank-based systems with a degree of democratic participation in the financial system not yet attempted in existing models.

Section three takes up this challenge. The angle through which it approaches this issue is to reexamine the different financial systems according to the exit/voice analytic framework developed by Hirschman.⁵ In this framework, exit is the withdrawal from a relationship with a person or organization when one becomes dissatisfied with that relationship. Voice means directly expressing one's dissatisfaction to the relevant person or organization. In capitalist societies, the exercise of exit is pervasive within market relationships, while the political and bureaucratic spheres are dominated by the exercise of voice. Within this framework, the fundamental distinction between financial systems can be seen to be not whether they are bank- or capital market-based, but rather whether they are dominated by exit or voice mechanisms. The bank-based systems are voice-led, and therefore provide more effective channels for political interventions in financial markets than do the exit-led capital market systems. Working from this perspective, the principal concern in formulating egalitarian policies can be recast: the issue is not the specific bank or capital market institutions prevailing in a financial system, but rather how all systems can be restructured to provide an effective basis for the democratic exercise of voice.

Posing the question in this way, then, enables us to consider various means of creating 'democratic-voice' mechanisms that also retain the efficiency and stability-promoting aspects of the existing bank-based financial structures, that is, the 'elite voice' systems. Drawing primarily from recent literature on the US economy, I consider proposals in the areas of

⁵ Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States*, Cambridge, Mass. 1970.

corporate governance, community reinvestment, pension-fund management, and central bank policy. However, I also stress that such democratic credit policies can be effective within a range of institutional frameworks and political environments. Indeed, the adaptability of this policy approach is one of its most important strengths. For example, while such proposals have operated successfully on a limited scale within the contemporary US economy, their effectiveness would probably increase within an economy, such as the French, where a high proportion of the major financial institutions are publicly owned.

In section four, I pose the following more general question: can the efficiency and stability-promoting features of a voice-led model be sustained once we move from an elite to a democratic-voice system? I approach the issue via the new model of 'bank-centric' market socialism developed by Bardhan and Roemer.⁶ Working from their discussion provides a bridge for engaging with the literature on market socialism in order to explore our central concerns about the efficacy of a democratic-voice model.

The brief concluding section pulls together the main arguments in support of such democratic-voice financial policies as a foundation for renewing egalitarian economic policies. In passing, this section notes that globalization and liberalization of financial markets pose new challenges to the viability of any bank-based or voice-led financial system. At the same time, experiences thus far suggest ways that the essential features of a voice system can be retained without having to resist all aspects of globalization.

II. Alternative Capitalist Financial Systems

1. Bank- and Capital Market-Based Systems

Beginning with Gershenkron's classic essay, there has been a small but now rapidly growing body of economic analysis which has attached significance to differences in the financial systems of capitalist countries.⁷ Gershenkron, in particular, contrasted the financial development of Britain and Germany. He argued that, because Britain's industrialization was early and gradual, businesses were financed primarily through reinvesting retained earnings. Large pools of intermediated saving had not yet formed, making it impractical for firms to rely on external sources for long-term financing. As a result, in the British tradition, non-financial firms did not develop close ties with financial institutions. When large financial institutions did later begin to develop, they were independent entities, with no special attachment to firms. The arm's length relationship between Britain's non-financial and financial sectors established the foundation for the country's highly developed and independent capital market.⁸

⁶ Pranab Bardhan and John Roemer, 'Market Socialism: A Case for Rejuvenation', *Journal of Economic Perspectives*, vol. 6, 1992, pp. 101-16.

⁷ Alexander Gershenkron, *Economic Backwardness in Historical Perspective*, Cambridge, Mass. 1962.

⁸ Tom Nairn traces the origins of the weak linkages between industry and finance in Britain even further back, to the era of the English revolution, during which the old landed classes and finance capital united to prevent the industrial bourgeoisie from controlling the state. Nairn, 'The Decline of the British State', *NLR*, 101-102, February-April 1977, pp. 3-61.

Gershenkron contrasts this pattern with that of Germany. Industrialization started later there, and as a result, firms were confronted with the problem of rapidly appropriating the capital technologies and production systems, such as those for steel, that the British had already developed. The firms were unable to finance these projects on their own and, as a result, large universal banks developed. They provided firms with both long-term funding as well as managerial direction. The universal banks were also able to coordinate the investment plans for the clusters of firms with which they were associated. Within this development path, opportunities were far more limited than in Britain for the formation of an independent capital market.⁹

As Jacobs points out, Gershenkron's account does not attempt to explain why the differences in the British and German systems were sustained long after Germany attained a comparable level of development to that of Britain.¹⁰ Nor does he pass judgement on the relative merits of either system as a foundation for future development. However, in roughly the last decade, a substantial literature has developed which has raised just these questions.¹¹ This literature has examined a wider set of countries than those considered by Gershenkron, including the US, Japan and

⁹ Gershenkron's historical account of the German experience conforms to the contemporaneous observations of Rudolph Hilferding, *Finance Capital: A Study of the Latest Phase of Capitalist Development*, London 1981 (first ed. 1891). However, Hilferding's analytic approach was mistaken for having regarded the German universal banking model as a more advanced and essentially inevitable stage through which capitalist economies would proceed. This perspective underestimated the durability of the British-type capital market model, as well as the evolution of banking enterprises themselves. Laurence Harris provides a good discussion of these issues. 'Alternative Perspectives on the Financial System', L. Harris, J. Coakley, M. Croasdale, and T. Evans, eds, *New Perspectives on the Financial System*, New York 1988, pp. 7–38.

¹⁰ Michael P. Jacobs, 'National Financial Systems, Aggregate Investment, and the Cost of Capital', manuscript, Department of Economics, New School for Social Research, 1994. This is comparable to the argument Ben Fine and Laurence Harris make about Nairn's thesis on the UK system—i.e. Nairn does not adequately explain why the British system remained in place through various historical junctures when political opportunities existed for restructuring it. *The Peculiarities of the British Economy*, London 1985.

¹¹ Some of the leading studies in this literature include John Zysman, *Government, Markets and Growth: Financial Systems and the Politics of Industrial Change*, Ithaca, 1983; Tad M. Rybczynski, 'Industrial Finance Systems in Europe, US and Japan', *Journal of Economic Behavior and Organization*, vol. 5, nos. 3–4, (1984) pp. 275–86; Andrew Cox, 'The State, Finance and Industry Relationship in Comparative Perspective', in A. Cox, ed., *The State, Finance and Industry*, Sussex 1986, pp. 1–59; Colin Mayer, for instance, 'New Issues in Corporate Finance', *European Economic Review*, 32, (1988) pp. 1167–89; Eric Berglöf, 'Capital Structure as a Mechanism of Control: A Comparison of Financial Systems', in M. Aoki, B. Gustafsson and O.E. Williamson, eds, *The Firm as a Nexus of Treaties*, London 1989, pp. 237–62; and Michael Porter, for instance *The Competitive Advantage of Nations*, New York 1992. Will Hutton's *The State We're In*, London 1995, is an excellent journalistic discussion of these issues, particularly as they relate to the contemporary British economy. Recent studies examining these questions from political economy perspectives, and from which I have benefited substantially are Don Goldstein, 'Financial Structure and Corporate Behavior in Japan and the US: Insulation vs. Integration with Speculative Pressures', manuscript, Department of Economics,

France among the core group, and others as well, depending on the particular questions that a given study is pursuing.

This recent literature has continued to find useful the fundamental distinctions established by Gershenkron, between what we are calling 'bank-based' and 'capital-market based' financial systems. Most generally, the capital market-based systems are characterized by highly developed capital markets, with widely dispersed ownership of equity and debt instruments, and relatively low involvement of large banks in either the allocation of funds or the ownership of financial assets. The bank-based systems, by contrast, are characterized by a small number of universal banks that are actively involved in the long-term financing of investment activity of the non-financial firms. The banks are the primary source of long-term funds and they retain ownership for the long term of their debt instruments. In these economies, there is relatively little secondary trading of financial assets.

Beyond this, Zysman's seminal contribution added a third dimension to the distinction between these systems: the nature of government involvement within them.¹² Zysman found strong differences in the role of government between Japan, France, Germany, the UK and US, the five countries he studied. In particular, he found that the government played a more limited role in the US and UK capital market-based systems. France and Japan, by contrast, were bank-based systems in which the government participates actively in allocating credit to private firms, both on the basis of price and quantity controls. Zysman argues that Germany is unique as a bank-based system in which the government does not play an active role in administering prices or quantities.

In contrasting the systems below, we begin by describing specific institutional features—that is, what distinguishes them as either bank or capital market-based—but advance toward the goal of generalizing more broadly about the two types of systems. I thus also describe the differences between the systems according to whether they are 'fluid' (capital market) or 'dedicated' (bank-based), and then, more expansively, according to whether they are 'exit' or 'voice' led systems. At the same time, in generalizing this way about the nature of these systems, I do not mean to give the impression that actual financial operations in the various countries have, over the period considered, become frozen in place. At various points, particularly in the conclusion, I discuss some of the ways that these systems have recently evolved. Nor am I suggesting that differences in financial systems can themselves explain overall differences in economic performance. The Japanese or South Korean growth 'miracles', for example, were crucially dependent on, among other things, initial support

Allegheny College, 1995; Ilene Grabel, 'Saving and the Financing of Productive Investment: The Importance of National Financial Complexes', in R. Pollin ed., *The Macroeconomics of Finance, Saving and Investment*, Ann Arbor 1996 (forthcoming); and Michael P. Jacobs, 'National Financial Systems, Aggregate Investment, and the Cost of Capital' and 'A Cluster Analysis of Twelve Countries' Financial Systems', Essay I, Ph.D. Dissertation, New School for Social Research, 1994.

¹² John Zysman, *Government, Markets and Growth: Financial Systems and the Politics of Industrial Change*, Ithaca, NY 1983.

from the US economy through spending on the Korean and Vietnam wars and other factors, docile labour movements, well-specified export strategies, and strong commitments to spending on education.¹³ Nevertheless, by focusing here on the issue of financial structure, I am clearly assigning considerable significance to its relative importance as a determinant of overall economic performance.

2. Effects of Alternative Systems

Why do these features of countries' financial systems matter? The answer first depends on the theoretical perspective from which one examines the question. Given the neoclassical 'irrelevance' propositions developed by Modigliani and Miller, financial structure should not matter at all in determining either the valuation of firms or, more generally, the pattern of investment.¹⁴ This is because, in perfectly competitive markets, the same product (a firm) will be priced equally in separate markets (debt and equity markets). So there can be no advantage to firms or their asset holders derived from the firm's capital structure.

Because the Modigliani-Miller thesis assumes the existence of perfectly competitive markets, it follows that 'financial deepening'—the development of sophisticated financial markets through which the transaction costs of reaching one's optimal risk/reward profile are low—will enhance efficiency. This was the view developed by MacKinnon and Shaw specifically with respect to the financial markets of less developed economies, but their perspective applies generally.¹⁵ From this point of view, then, one would conclude that the Anglo-Saxon capital market-based model of deep and liberalized financial markets would attain superior results to the bank-based systems such as France, Japan or Germany. In fact, most of the literature has found the contrary to be the case: over a range of measures, the bank-based systems have out-performed the capital market-based systems. What are the reasons for this?

¹³ For fuller treatments of these economies, see Makoto Itoh, *The World Economic Crisis and Japanese Capitalism*, New York 1990 on Japan, and Alice Amsden, *Asia's Next Giant*, New York 1989, Martin Hart-Landsberg, *The Rush to Development: Economic Change and Political Struggle in South Korea*, New York 1993 and Ha-Joon Chang, *The Political Economy of Industrial Policy*, New York 1994 on South Korea.

¹⁴ Franco Modigliani and Merton Miller, 'The Cost of Capital, Corporation Finance, and the Theory of Investment', *American Economic Review*, June 1958, pp. 261–95.

¹⁵ See Ronald MacKinnon, *Money and Capital in Economic Development*, Washington, DC, 1973, and Edward S. Shaw, *Financial Deepening in Economic Development*, New York 1973. Grabel presents, among other things, an illuminating survey of the MacKinnon/Shaw thesis. Ilene Grabel, 'Speculation-led Economic Development: A Post-Keynesian Interpretation of Financial Liberalization Programs in the Third World', *International Review of Applied Economics*, vol. 9, no. 2, (1995), pp. 127–49. It is notable that MacKinnon himself has revised his position allowing that some forms of state intervention may be needed to address problems of asymmetric information. See for instance his 'Macroeconomic Instability and Moral Hazard in Banking in a Liberalizing Economy', in P. Brock, M. Connolly and C. Gonzalez-Vega, eds, *Latin American Debt and Adjustment. External Shocks and Macroeconomic Policies*, London 1989, pp. 99–111.

The literature here builds from a range of perspectives. Some of it, within the Gershenkron tradition, is primarily historical and descriptive (for instance Zysman and Cox). More explicit theoretical approaches are motivated by New Keynesian and New Institutional concerns with problems of information and principal/agent relationships, Post-Keynesian ideas on uncertainty and financial fragility, and from what is increasingly termed the 'organizational capabilities' view of the firm.¹⁶ Perhaps the single most influential idea underlying this literature is traceable to Berle and Means's classic 1932 study of the development of US corporations.¹⁷ They argued that the growth of the corporate form of organization would encourage a divergence in the interests of managers and owners—what is now termed a principal/agent problem. The problem is that managers, as agents of a dispersed and unorganized set of owners within a capital market-based financial system, will act on behalf of their own interests which are not necessarily identical to, or even compatible with, those of the firm's owners. Managers, for example, may seek to maximize their own salary, security, power and perquisites, rather than the shareholder's value; this would constitute a classic instance of an incentive incompatibility between principal and agent.

At least equally problematic is that, even if the Berle/Means-type incentive incompatibilities were resolved satisfactorily, this in itself is still not likely to promote the long-term viability of the firm. The reasons for this stem from the related problems of asymmetric information between owners and managers, incentive incompatibilities between owners and the firm's workers, and the uncertainty that dominates the operations of financial markets. To begin with, the information to which the shareholders tend to respond will be short-term financial indicators. These are not necessarily congruent with the firm's ability to produce desired products at competitive costs, the basic determinant of the firm's long-term viability. Shareholders will recognize obvious cost-reducing measures, such as wage cuts or layoffs, and will respond favourably to these. Yet other sources of long-term viability, such as the firm's capacity to innovate technically and its ability to create a productive environment for its workers,

¹⁶ Stiglitz is a background reference on New Keynesian perspectives on informational problems and financial structure. See for instance Joseph E. Stiglitz, 'Banks vs. Markets as Mechanisms for Allocating and Coordinating Investment', in J.A. Roumasset and S. Barr, eds, *The Economics of Cooperation: EastAsian Development and the Case for Pro-Market Intervention*, Boulder, 1992, pp. 15–38. For a discussion of Post-Keynesian perspectives on uncertainty and financial fragility, see James Crotty, 'Are Keynesian Uncertainty and Macroeconomics Compatible? Conventional Decision Making, Institutional Structures and Conditional Stability in Keynesian Macromodels', in G. Dymski and R. Pollin, eds, *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman P. Minsky*, Ann Arbor, 1994, pp. 105–142. For alternative versions of an 'organizational capabilities' view, see Michael Porter, *The Competitive Advantage of Nations*, New York 1990; and William Laznick, 'Organizational Capabilities in American Industry: The Rise and Decline of Managerial Capitalism', *Business and Economic History*, (second series) 19, 1990, pp. 35–54, and 'Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism', *Industrial and Corporate Change*, vol. 1, no. 3, (1992) pp. 445–88.

¹⁷ Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property*, New York 1932.

are likely to be unrewarded or even denigrated by shareholders. This is in part a problem of asymmetric information, in that shareholders are not adequately informed about the firm's operations. But there is also the perhaps more basic problem of incentive incompatibilities, or, in straightforward terms, class conflict. Since longer-term sources of productive viability may not reduce costs in the short term, the benefits of them will not flow to shareholders who are most interested in the short-term capital gains stemming from rising asset prices. On the other hand, the benefits of maintaining competitiveness through creating a productive work environment rather than wage-cutting and layoffs is clearly in the interest of the firm's workers.

Finally, as Post Keynesians have long argued, asset prices in deep capital markets are heavily influenced, if not entirely dominated, by the activities of speculators, whose only concern is to outguess the market, not evaluate a firm's productive potential.¹⁸ Thus, far from enhancing the flow of useful information between owners and managers, a deep and freely functioning financial market is more likely to encourage chronic bouts of speculative financial excess or, in contemporary terminology, pervasive 'coordination failures'.

The argument within the literature is that the bank-based systems resolve these problems of asymmetric information, uncertainty and coordination failure, as well as class conflict and other incentive incompatibilities more successfully than the capital market-based systems. As a result, the bank-based systems achieve superior performance in three crucial areas: promoting longer time horizons, encouraging financial stability, and providing a framework for the successful implementation of government policy.

3. Time Horizons and Financial Stability

The most basic reason given in the literature for the superior performance of the bank-based systems is that they foster long-term time horizons, which in turn promote long-term productive investment. By contrast, the capital market-based systems foster shorter time horizons, in that firms' managers are primarily concerned with achieving the performance standards defined by the transactions-oriented capital markets.

It will be useful now to consider Porter's terminology, in which the two systems are distinguished according to whether they are 'fluid' or 'dedicated' capital systems. In the fluid capital systems, firms' relationships with capital suppliers are at arm's length, so shareholders have limited information and direct influence over managerial actions. Shareholders and bondholders' decisions are made on the basis of simple corporate financial ratios and stock prices. Moreover, their interventions in the corporate governance process are primarily ex-post, for instance through the sale of shares or the deterioration in bond ratings. Within this arrangement, managers are forced to follow the same standard financial measures of performance.

¹⁸ This point is developed well in James Crotty, 'Are Keynesian Uncertainty and Macrotheory Compatible?'

In ‘dedicated capital’ systems, by contrast, the capital suppliers have major stakes and long-term relationships with the non-financial firms. This enables the capital suppliers to share a focus with managers on technical expertise and building market positions. Capital suppliers are thus able to exert ex-ante influence. The firms, in turn, benefit from what Lazonick calls ‘financial commitment’, which he defines as a situation in which claimants to the firms’ revenues ‘will not enforce these claims in ways that undermine the development and utilization of the firms’ organizational capabilities’.¹⁹ With this type of financial commitment associated with dedicated capital systems, the factors that are conducive to high performance among workers—including less hierarchical work structures and long-term employment security—have a far greater opportunity to develop. In addition, the ex-ante flow of information and control in dedicated capital systems induces a greater tolerance on the part of the lenders and investors for higher leverage ratios. At the same time, the capital market-based systems are more susceptible to financial instability than the bank-based systems. Why is this so? The underlying source of financial instability, at the simplest level of accounting, must be that debt commitments are systematically outstripping the income flows necessary to service them. In turn, the basic explanation for the systematic deviation between debt commitments and income flows is that borrowed funds are used disproportionately to finance activities that do not yield an adequate return flow of income. The types of debt-financed activities most likely to create such a debt trap are speculative and compensatory spending, that is, borrowing to purchase existing assets with the expectation of capital gain and to compensate for declining income streams or other internally generated funds. Put another way, instability results when debt is used insufficiently to finance productive spending, that is, spending that raises incomes by enhancing the productive capacity of firms and individuals. When credit is extended for speculative and compensatory spending to a disproportionate degree relative to productive spending, the likely result will be income streams inadequate to finance the growth of debt.²⁰ Note here that the basic source of difficulties is not the rise of debt per se, nor even the rise of debt relative to income or assets. High leverage ratios are sustainable as long as, over time, a return flow of revenue is generated to service them.

As a general model, the bank-based systems are better designed to avoid such mismatches between debt commitments and income flows since, with finances more committed to long-term projects, speculative impulses are weakened. This in turn means that projects will have a longer grace period before they have to generate returns to their lenders.

¹⁹ Lazonick, ‘Organizational Capabilities in American Industry’, p. 51.

²⁰ The most influential contemporary perspective on financial instability has been developed by Hyman P. Minsky, for instance in *Stabilizing an Unstable Economy*, New Haven, 1986. For various perspectives on and developments from the Minsky approach, see Steven Fazzari and Dimitri B. Papadimitriou, eds, *Financial Conditions and Macroeconomic Performance: Essays in Honor of Hyman P. Minsky*, Armonk, NY 1992, and Gary Dymski and Robert Pollin, eds, *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman P. Minsky*, Ann Arbor, 1994.

4. Evidence on Time Horizons and Financial Stability

Time Horizons, Cost of Capital and Investment

A wide range of research has accumulated in recent years supporting the view that the bank-based systems have promoted longer time horizons and greater financial stability. To begin with, survey evidence of corporate chief executive officers (CEOs) in the US, Japan and Europe developed by Poterba and Summers found that American CEOs believe that their time horizons are shorter than those for their counterparts in Europe and Japan.²¹ These managers claim that their relatively short horizons derive to a significant extent from the financial market environment in which they operate, since they believe that US equity markets undervalue long-term investments. Were the firms valued more in accordance with the perceptions of managers, they believe that their long-term investments would increase, on average, by perhaps as much as 20 per cent.

The survey also found that for the US CEOs, the minimum expected rate of return that would induce them to commit to a new investment project—i.e. the ‘hurdle rate’—is substantially higher than standard cost-of-capital analysis would suggest. On average, CEOs in the US reported that their hurdle rate was 12.2 per cent. This compares with an average real return over the past fifty years of less than 2 per cent on corporate bonds and around 7 per cent for equities.

Moreover, as Porter reports, this difference in time frames and hurdle rates is associated with a striking difference in managerial goals: US managers rank return on investment and higher stock prices as their top two corporate objectives, whereas Japanese managers rank improving existing products or introducing new ones, and increasing market share as their two highest priorities.²² Higher stock prices are ranked last by Japanese managers among the eight objectives included in the study.

These survey findings are also consistent with evidence from corporations’ actual operations. Porter found that the share of investment going to research and development, intangibles (especially investment in ‘corporate training and human resources’) and plant and equipment is lower in the US than in Germany and Japan. In addition, the proportion of total research and development expenditures going to long-term projects is lower in the US. In the US, 22.6 per cent of total R&D budgets were allocated to such projects, while in Japan and Europe, the figures were 46.8 and 60.5 per cent respectively.²³

Related to this, recent studies also find that short-term financial market pressures have created formidable obstacles to developing ‘high-performance’ work environments, despite the increasingly widespread recogni-

²¹ James Poterba and Lawrence Summers, ‘Time Horizons of American Firms: New Evidence from a Survey of CEOs’, manuscript, Department of Economics, Massachusetts Institute of Technology, 1992.

²² Michael Porter, *Capital Choices: Changing the Way America Invests in Industry*, Washington, DC 1992.

²³ *Ibid.*

tion of the long-term gains that are achievable through a more secure and less hierarchical workplace. Thus, Appelbaum and Berg report on the results of a 1995 survey of senior line and human resource executives at mid-sized and large US companies. The survey found that 98 per cent of respondents agreed that improving employee performance would significantly improve business results while 73 per cent said that their company's most important investment was in people. Still, when asked to rank a number of business priorities, the respondents put performance of people and investment in people near the end of the list, well below standard measures of financial performance.²⁴

Considering more direct financial indicators, at least over the 1970s and 1980s, various studies have found that the real after-tax cost of capital was higher in the US than Japan and Germany, and that differences in these countries' financial systems are seen as a major contributing factor. McCauley and Zimmer, for example, write that greater integration of industry and finance has permitted higher leverage without raising bankruptcy risks equivalently, and also greatly reduced liquidity risks of non-financial firms. Moreover, the Japanese and German governments are more actively involved in mitigating the direct costs associated with non-financial firms' periods of financial distress.²⁵

Mergers, Takeovers and Speculation

It is consistent with these general findings that the bank-based systems almost fully avoided the corporate mergers, buyouts and takeovers that were pervasive within the US and the UK in the 1980s. Indeed, according to the work of Michael Jensen, the most influential mainstream analyst of the 1980s merger and buyout wave, the phenomenon in the US and the UK represented precisely an effort to resolve the principal/agent problems resulting from the Anglo-American financial system. This effort was almost entirely salutary in Jensen's view.²⁶

Jensen argues that the market for corporate control, and the corporate restructurings it has forced, remedies the incentive, coordination and informational problems of the Anglo-American corporate form using straightforward means: limiting the prerogatives of managers and increasing the control of owners. Managers are forced to face constant threats to their power and position, and are therefore much more responsive to shareholders' interests. This view also holds that the substitution of debt for equity is a powerful tool for reducing management authority over unutilized cash flow because, unlike dividend payments to equity owners, managers are legally bonded to distribute interest payments on their debt.

²⁴ Eileen Appelbaum and Peter Berg, 'Financial Market Constraints and Business Strategy in the US', in J. Michie and J. Grieve Smith, eds, *Restoring Full Employment: Rebuilding Industrial Capacity*, Oxford 1996, forthcoming.

²⁵ Robert N. McCauley and Steven A. Zimmer, 'Explaining International Differences in the Cost of Capital', *New York Federal Reserve Bank Quarterly Review*, summer 1989, pp. 7–28.

²⁶ See for instance, Michael Jensen, 'The Takeover Controversy: Analysis and Evidence', in J. Coffee Jr., L. Lowenstein and S. Rose-Ackerman, eds, *Knight, Raiders and Targets: The Impact of the Hostile Takeover*, New York 1988, pp. 314–54.

Following this perspective, one would expect that the enormous investment in corporate takeovers in the 1980s would have generated comparably large net benefits to the US and UK economies. While considerable controversy exists over evaluating the outcome, a careful survey by Crotty and Goldstein of the US experience found that the overall social costs far exceeded the benefits:

The evidence is mounting that the costs of creating and allocating credit through the deregulated financial markets of the 1980s are likely to be significant and persistent. In many cases, employees in merged firms suffered a direct loss of security, income and/or jobs. The spill overs from these losses have been substantial; communities have suffered, and workers' commitment to productivity growth has been badly shaken. Productivity is threatened also by the constraining effects of debt on investment and R&D expenditures. And finally, the financial stability and flexibility of industrial and commercial companies and financial institutions throughout the economy has been impaired.²⁷

This is not to say that speculative finance is absent in the bank-based systems. The 1980s inflation of the Japanese stock market and its crash in 1989 provide dramatic evidence that volatility there is comparable to that in the US and UK.²⁸ But the crucial point is that, because of the close relationship between financial and non-financial firms in bank-based systems, speculative financial behavior does not exert significant influence on real economic activity. In Japan itself, for example, controlling blocks of many firms' shares are held among strategic partners within Keiretsu, the bank-industry clusters. Yet roughly 40 per cent of corporate stock is held by non-allied shareholders. This segment of the Japanese market is even more engaged in short-term trading than the US market, with the net result being that overall trading volume and turnover are very similar in the two countries. Goldstein describes the Japanese financial market as strongly bifurcated into fluid and dedicated segments, with the latter still exercising predominant influence.

5. Economic Policy under Alternative Systems

Broadly speaking, bank-based systems are structured more suitably than capital market-based systems for achieving favourable results from two primary policy tools—expansionary policy and industrial strategy. The basic source of the advantages inherent in bank-based systems is the greater integration between non-financial and financial firms, which engenders a commonality of purpose that is absent in capital market-based systems.

²⁷ James Crotty and Don Goldstein, 'Do US Financial Markets Allocate Credit Efficiently? The Case of Corporate Restructuring in the 1980s', in G. Dymski, G. Epstein and R. Pollin, eds, *Transforming the U.S. Financial System: Equity and Efficiency for the 21st Century*, Armonk, NY 1993, p. 276.

²⁸ Don Goldstein, 'Financial Structure and Corporate Behavior in Japan and the US: Insulation vs. Integration with Speculative Pressures', manuscript, Department of Economics, Allegheny College, 1995.

Expansionary Macro Policy

In bank-based systems, since banks hold equity positions and are active in the management of firms, the banks, along with the non-financial firms, will be more favourably disposed toward expansionary macro policies. In the Anglo-American system, where financial firms are not directly linked to industry, the financial firms are more likely to favour restrictive policies. The value of outstanding financial assets are more important to the Anglo-American financial firms than the growth prospects of non-financial firms, and as such, they are more concerned about the threat of inflation than comparable institutions in bank-based systems.²⁹

These attributes are reflected in the central bank policies of different types of countries. In the US and UK, the central bank has a relatively high degree of independence which over time has evolved into a close alliance with financial interests. These banks have therefore tended to favour restrictive policies. In the bank-based systems, where there is a strong link between bank and industry, biases toward restrictiveness tend to be weaker, though Germany, with its combination of a bank-based system and a highly independent central bank, is a clear exception to this general tendency.³⁰

Related to this, in the US/UK model, the independence of the financial system has led to a strong international orientation for its financial sector. In both cases, the domestic currency is used extensively for international transactions, and a formidable industry has developed around international finance. Maintenance of confidence in the currency is therefore given greater priority than in bank-based systems.³¹ It also appears that the negative collateral effects of expansionary policy tend to be stronger in the Anglo-American than the bank-based systems, though more research is needed to establish this point. The most general problem is that expansionary policy in capital market-based systems are more likely to engender an allocation of credit toward speculative finance, such as mergers, buyouts, and real-estate investments. Again, the bank-based

²⁹ This argument is developed theoretically and empirically in Gerald and Juliet Schor, 'Macropolicy in the Rise and Fall of the Golden Age', in S. Marglin and J. Schor, eds, *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*, New York 1990, pp. 126–52.

³⁰ Gerald Epstein ranks the central banks of OECD countries according to their degree of independence. ('A Political Economy Model of Comparative Central Banking', in G. Dymski and R. Pollin, eds, *New Perspectives in Monetary Macroeconomics: Explorations in the Tradition of Hyman P. Minsky*, Ann Arbor, 1994, p. 259.) By his ranking, in the early 1990s, Germany had the most independent bank, followed by the US and UK. This situation has been evolving since the time of Epstein's ranking, given that the establishment of independent central banks has become a major policy aim within the international banking community, including policy makers at the International Monetary Fund and those directing the movement toward a European Monetary Union. As one important measure of this change, legislation was enacted in France in 1992 mandating that its central bank become independent, and steps toward implementing this policy change have been advancing steadily. This development will have important implications for the future viability of bank-based systems. Here, however, we are primarily concerned with the lessons to be learned from recent past experiences.

³¹ See Fine and Harris, *The Peculiarities of the British Economy*, pp. 61–2, and Epstein and Schor, 'Macropolicy in the Rise and Fall of the Golden Age'.

systems have high degrees of speculation as well but at the core of the credit market systems are institutional provisions for productive finance.

Financial Markets and Industrial Strategy

The advantage of bank-based systems here is that they are more amenable to public credit allocation policies as a central focus of industrial strategy.³² Public credit allocation policies, in turn, are regarded in much of the literature as an effective instrument of industrial strategy. At the same time, in considering the historical experience—particularly that of the US, which has pursued extensive public credit policies—the actual causal relationships between a country's financial structure, its degree of public credit allocation, and its efforts and attainments in the area of industrial strategy, are not clear-cut. That is, while it may appear that countries with bank-based systems are more successful at implementing credit policies and industrial strategy, this may primarily result from the fact that the same countries are more actively engaged in both credit allocation and industrial strategy. Relatedly, the historical record is not clear on the extent to which countries with capital-market systems can deploy credit policies to compensate for the capital market's distortions—that is, engaging credit policies to replicate the desirable features of a bank-based system within the existing capital market institutional framework. We return to these questions in section three; as a prelude to that discussion, I now briefly review the experiences of various countries with credit policies and industrial strategies.

Zysman, for one, argues emphatically that public credit allocation policies are necessary—indeed are the one essential tool—for successfully implementing industrial strategies. He says there are two reasons for this. The first is that:

business decisions are hard to control or influence through administrative or regulatory rules. Those same decisions may, however, be influenced by negotiation in which the payment for services rendered is unambiguously calculated in monetary terms. Discretionary influence in industrial finance permits the government to deal within the framework of business decisions and to affect the balance sheet directly.³³

In addition, Zysman argues that public credit allocation is a universally applicable policy instrument. As such, it 'eliminates the need to find specific authority to influence specific decisions or to control an agency that

³² Following Sawyer, I use the term 'industrial strategy' rather than 'industrial policy'. Sawyer draws a distinction between a broad notion that government 'can play a positive enabling role in the economy and that institutions . . . can have a beneficial influence on the workings of the economy', associated with 'industrial strategy'; and the narrower the concept of 'industrial policy' as equivalent to 'competition policy'. Malcolm Sawyer, 'Industrial Strategy and Employment in Europe', in J. Michie and J. Grieve Smith, eds, *Unemployment in Europe*, London 1994, p. 177. Other useful discussions of the meaning of industrial policy are presented in Chang, *The Political Economy of Industrial Policy*, and Grahame Thompson, 'Grounding Industrial Policy?', *International Review of Applied Economics*, vol. 9, no. 2, (1995) pp. 221–8.

³³ Zysman, *Government, Markets and Growth*, pp. 76–7.

has formal authority over a specific policy instrument.’ By comparison, Zysman contends that tax policy is not nearly as effective a policy tool. Taxes tend to operate on gross profits from earnings, and thus are an ex post rather than ex ante incentive to pursue the priorities of the industrial strategy. Tax policy is also less flexible; it can be reasonably used to target categories of activity but not specific industrial ends.³⁴

Despite differences of detail, there appear to be three basic common elements to public credit allocation policies among the countries that have used such policies for financing an industrial strategy. To begin with, the national government is the major initial recipient of the economy’s saving supply. This is achieved through various mechanisms: in Japan, it is done through the postal saving system, in France and Taiwan through the public ownership of banks. In South Korea, public bank ownership was supplemented by the government running persistent budget surpluses. Through all these mechanisms, the state has power to act as the economy’s principal financial intermediary.³⁵

From here, the state is then able to utilize the disbursement of credit as a policy tool. This can be done either by disbursing to private intermediaries, as is done in the Japanese system, or by the state making direct loans to non-financial firms, as is done in France or Korea.³⁶ Finally, powerful state agencies—such as MITI in Japan and the Trésor in France—are in a position to easily monitor the progress of their industrial strategy via their oversight of the return flow of debt servicing by the borrowing units.

Experiences in the US and UK

The US and UK have had divergent experiences with respect to public credit allocation and industrial strategy. Since the 1930s, the US has had considerable

³⁴ Working with US data, Thomas Karier for example finds that tax credits to stimulate private investment are highly inefficient: only 12 per cent of the credits are actually spent on new investment. The other 82 per cent are used to pay higher dividends, buy stocks or bonds, or otherwise reduce reliance on external sources of funds. Karier, ‘Investment Tax Credit Reconsidered: Business Tax Incentives and Investments’, The Jerome Levy Economics Institute of Bard College Public Policy Brief, no. 13, 1994. On the other hand, Stiglitz raises concerns about credit subsidy programs because the costs are diffuse and difficult to calculate. Joseph E. Stiglitz, ‘The Role of the State in Financial Markets’, manuscript, Department of Economics, Stanford University, 1993, p. 5.

³⁵ Note that the state collection of private saving also enables the state to provide deposit insurance without facing the moral hazard problem—encouraging excessively risky lending practices by private intermediaries carrying government guaranteed deposits—that exists with a public deposit insurance/private intermediation system such as that in the US. It was precisely this problem in the US that was the proximate cause of the Savings and Loan fiasco. See Martin H. Wolfson, ‘The Evolution of the Financial System and the Possibilities for Reform’, in G. Dymksi et al, eds, *Transforming the U.S. Financial System*, pp. 133–56.

³⁶ Chang discusses how a combination of quantity rationing and interest-rate subsidies were used in South Korea to promote the domestic machinery industry. He writes that ‘credits were usually refused to those who wanted to import domestically available machines, and instead subsidized credits, which sometimes amounted to 90 per cent of the product value, were provided to the purchasers of domestic machinery.’ Chang, *The Political Economy of Industrial Policy*, p. 102.

experience with public credit allocation policies. Indeed, considering all forms of credit allocation—direct loans, guaranteed loans and government-sponsored enterprise loans—the federal government is the largest creditor in the US financial market, lending or underwriting on an annual basis between about 15–30 per cent of all loans. Major recipients of funds have been the housing sector, agriculture and education. These programmes, moreover, have achieved considerable success relative to their stated goals. For example, they have contributed substantially to the unprecedented access to home ownership enjoyed by a high proportion of the non-wealthy in the US.³⁷

The extent and successes of these programmes demonstrate that credit policies can be implemented effectively within a capital market-based financial system. At the same time, while these policies have been crucial to the development of targeted sectors, they have not been used in the US to guide an overall industrial strategy. It is therefore difficult to gauge the extent to which a broader-based set of credit–industrial policies might be frustrated by the structure of US financial markets. However, the success of these programmes on their own terms suggests, contrary to Zysman, that the ability to successfully implement credit allocation policies may not depend significantly on whether a country’s financial system operates as a bank- or capital market-based system.

As for the UK, the Labour party governments in the 1960s and 1970s did attempt to pursue industrial strategies but without using public credit allocation policies as part of that effort. The private capital market financial system thus acted as a barrier to the successful attainment of industrial policy. As Zysman writes:

Despite Labour’s hope of reforming capitalism, the government had neither the instruments to do so nor a conception of how to manipulate the industrial economy . . . Physical controls, which proved unworkable, were seen as the only alternative to a reluctant endorsement of the market system. Even nationalization did not alter the fundamentally arm’s length relations between government and the now-public companies . . .³⁸

6. Objectionable Aspects of Bank-Based Systems

Despite the many successful features of bank-based systems, they also have serious deficiencies, in particular from the perspective of constructing an egalitarian economic programme. The close, interlocking relationships between major firms, banks and government bureaucracies create opportunities for clientism in credit allocation.³⁹ Even more objection-

³⁷ A basic reference on the development of federal credit programs in the US is Barry P. Bosworth, Andrew S. Carron and Elisabeth H. Rhyne, *The Economics of Federal Credit Programs*, Washington DC 1987.

³⁸ Zysman, *Government, Markets and Growth*, p. 82; see also Fine and Harris, *The Peculiarities of the British Economy*, pp. 123–4.

³⁹ Considering the East Asian economies, small- and medium-sized firms were clearly discriminated against in their access to subsidized credit. Yet, these firms did still benefit from the public credit policies as suppliers to the larger, directly subsidized firms. Moreover, in Japan and more recently in South Korea, the government also allowed small- and medium-sized firms to take shelter behind legislation allowing them to cartelize. See Amsden, *Asia’s Next Giant*, pp. 180–4.

able from the perspective of constructing an egalitarian programme is the fact that public credit allocation policies have been most successfully implemented in countries such as Japan, South Korea and Taiwan where government planners were completely independent from democratic decision-making processes. In France, as in the East Asian economies, government credit policies were independently established within the elite Trésor unit of the Treasury but these policies were still subject to some democratic pressures within the framework of the French polity. But for just this reason, Cox argues that public credit allocation policies in France were less successful than those in Japan: that is, the French were forced to a far greater degree to use these policies to simply subsidize ailing industrial firms, avoiding the social costs of closing the plants.⁴⁰ Regardless of the accuracy of Cox's assessment, the point he raises is important. He is suggesting that the more the state is a site of political conflict, the greater the likelihood that credit allocation policies will become an instrument for competing, rent-seeking constituencies. Such observations raise questions about the idea that public credit allocation policies can be successfully implemented within a democratic framework—much less, as we are proposing, that such policies be the instrument for substantially extending democracy and improving economic performance. This is the basic question that we consider in the next section.

III. Democratic Finance and Egalitarianism

1. Exit and Voice in Financial Systems

Hirschman's exit/voice framework is important for this discussion because it provides a vehicle for exploring the extent to which financial systems can be used to increase equality as well as efficiency. Within this framework, the Anglo-American system is one dominated by exit as a means of exercising influence. Thus, dissatisfied shareholders or bondholders of a firm will typically express displeasure by selling their claims to the firm. A voice mechanism is incorporated into the US system through its extensive system of public credit allocation but, again, these programmes were designed with limited goals in mind and thus the voice mechanism is correspondingly limited.

By contrast, the bank-based financial systems are premised on the exercise of influence by voice. Major financial institutions and state agencies are actively involved in charting a non-financial firm's long-term plans and then committing themselves to the process of implementing those plans. At the same time, as we have noted, the exercise of voice in these economies is almost entirely confined to an elite grouping of capitalists, political leaders and high-level bureaucrats.

We pursue two specific questions here. The first is how the exercise of voice might operate within a democratic institutional framework while still retaining the capacity that exists with elite bank-based/voice systems to effectively solve incentive, coordination, and informational problems. Such a democratic extension of the voice mechanism would necessarily

⁴⁰ Cox, 'The State, Finance and Industry Relationship in Comparative Perspective'.

depend upon the development of collective organizations seeking to influence public credit allocation policies. These, in turn, could provide a foundation for building what Cohen and Rodgers call 'associative democracy,' that is, the attainment of 'egalitarian aims by improving the kinds and extent of collective organization available to citizens'.⁴¹ The second question, which we take up in the next section, is whether voice-dominated financial systems could be extended still further in an egalitarian direction, specifically to serve, in a manner suggested by Bardhan and Roemer, as a foundation for market socialist economies.⁴²

Problems with Exit-Dominated Systems

Hirschman himself discussed the Anglo-American financial model as an example of an exit-dominated system, and recognized the costs associated with such a system. He writes:

When the management of a corporation deteriorates, the first reaction of the best-informed stockholders is to look around for the stock of better-managed companies. In thus orienting themselves toward exit, rather than voice, investors are said to follow the Wall Street rule that 'if you do not like the management you should sell your stock.' According to a well-known manual this rule 'results in perpetuating bad management and bad policies.' Naturally it is not so much the Wall Street rule that is at fault as the ready availability of alternative investment opportunities in the stock market which makes any resort to voice rather than to exit unthinkable for any but the most committed stockholder.⁴³

To some extent, the merger movement of the 1980s can be interpreted as an attempt to overcome the hegemony of the exit option and create a vehicle for voice in the Anglo-American financial systems. It was a failed attempt, as we have seen, both in its own terms, because its enormous costs far exceeded its benefits, but also, more broadly, because of its highly constricted conception of which groups deserved to exercise voice (shareholders) and which should be excluded (all stakeholders).

Combining Exit and Voice

While Hirschman's argument points toward the benefits of a strong voice option, he also recognizes that the most favourable situation is one that achieves an appropriate balance between exit and voice. Reaching such a balance, however, is difficult. To begin with, voice can atrophy in situations when both options are available but exit is highly accessible. Consider, for example, an important case in which a voice mechanism was injected into the exit-dominated US financial system. This is the experience since 1977 with the Community Reinvestment Act (CRA). Under the terms of the CRA, banks are obliged to provide funds for the communities

⁴¹ Joshua Cohen and Joel Rodgers, 'Associative Democracy', in P. Bardham and J. Roemer, eds, *Market Socialism: The Current Debate*, New York 1993, p. 236.

⁴² Bardhan and Roemer, 'Market Socialism', pp. 101-16 and Bardhan and Roemer, eds, *Market Socialism*.

⁴³ Hirschman, *Exit, Voice and Loyalty*, p. 46.

in which they operate. However, this regulation exists within a highly unfavourable environment. The banks, in dealing with small-scale borrowers, generally seek to package standardized loans into marketable securities for the national and global market. Almost by definition, loans that bring new opportunities to poor communities will tend not to meet the conditions of the standardized loans. In addition, local communities have no institutional means of monitoring bank compliance with the law. Not surprisingly, the CRA has had little impact on bank lending practices.⁴⁴

It follows that exit options must be limited in order that voice be effective. But it is also true that an environment which lacks a credible exit option is also not viable. Without the exit option, the sanctions one can threaten when expressing dissatisfaction will carry little credibility.⁴⁵ Considering financial markets, the bifurcated Japanese market offers a useful model. There, as we have seen, controlling blocks of firms are closely held within Keiretsu, who manage their interlocking companies through the exercise of voice. At the same time, because roughly 40 per cent of financial assets are publicly traded, a viable exit option is provided which also transmits the public market's assessment of a firm's performance. This also creates wide opportunities for speculative finance, but they generally do not diminish the 'financial commitment' (referring again to Lazonick's term) of the Keiretsu to the long-term operations of a firm.

These observations point toward an important generalization: what is crucial in organizing an efficient financial system is not whether the system is bank- or capital market-based, but rather, how to attain the appropriate mix of voice and exit. We observe that a strong voice option is needed to resolve the incentive, coordination, and informational problems in a financial system in a way that encourages long time horizons and financial stability. But a viable exit option must also exist to at least lend weight to dissatisfied voices. Posing the issue this way allows for greater flexibility—and even optimism—in addressing policy issues. The initial policy problem is not to anoint one system (bank-based) while rejecting the other (capital market-based), for both have evolved in various countries over long periods of history and are unlikely to be displaced in toto. The actual challenge appears rather more manageable: how, within given existing institutional environments, can voice be strengthened sufficiently without smothering exit.

2. Political Power and the Exercise of Voice

Of course, giving priority to voice over exit does not at all address the issue of whose voice is being empowered. In existing bank-based systems, as we have discussed, the extension of the voice option is quite limited. Can voice-dominant financial systems be viable when the voice option is substantially extended?

⁴⁴ For a discussion of the Community Reinvestment Act, see James T. Campen, 'Banks, Communities and Public Policy', in G. Dymksi et al, eds, *Transforming the US Financial System*, pp. 221–52.

⁴⁵ Such, for example, was the case in the former Soviet economy. One important reason adequate quality controls did not exist was that consumers could never threaten to take their business elsewhere.

In considering this question, it will be useful to consider a formulation by Edward Banfield to which Hirschman refers: 'The effort an interested party makes to put its case before the decision maker will be in proportion to the advantage to be gained from a favourable outcome multiplied by the probability of influencing the decision'.⁴⁶ Drawing from this framework, the challenge can be defined as developing institutions through which there is both advantage to be gained from exercising voice and a good probability that advantage will be so gained. In capitalist societies, of course, the wealthy have far greater means to organize effective voice mechanisms. Indeed, a legitimate criticism of efforts to extend the voice option is that this will merely generate new vehicles for rent-seeking—and attaining—by the wealthy. This is why means to strengthen associative democracy are crucial components of strengthening the voice option, especially, as Cohen and Rodgers write, 'efforts to promote the organized representation of excluded interests'.⁴⁷ How can this be done within financial systems?

A dramatic intervention in this direction would be to nationalize a substantial proportion of a country's financial institutions. We put aside whether such a strategy is politically feasible. However, an even more basic concern is whether a nationalization strategy, on its own, is likely to change the structure of a country's financial institutions in any significant way, and specifically whether it is likely to promote the extension of voice.

The French experience is instructive. Roughly half of the French banking system has been nationalized since the 1940s and the Mitterand government nationalized another 30 per cent after coming to power in 1981. Nevertheless, as Lipietz, among others, has written, the financial system operated in a manner essentially indistinguishable from private banks, both before and after 1981.⁴⁸ Moreover, the Mitterand government's decision to nationalize was never linked to a broader strategy of financial market democratization or even experimentation. Quite the contrary: the government's first major policy decision was to defend financial orthodoxy with respect to the exchange rate, a position it consistently maintained thereafter.⁴⁹

A nationalization policy thus begs the question of how to promote a democratic voice within financial institutions. More to the point are a range of proposals that have been developed recently which, given existing property relations, focus on specific methods of extending the voice mechanism. For illustration, I will cite some that have been developed primarily within the US context, but the basic approach is generalizable

⁴⁶ Edward Banfield, *Political Influence*, New York 1961; cited in Hirschman, *Exit, Voice and Loyalty*, p. 39.

⁴⁷ Cohen and Rodgers, 'Associative Democracy', p. 238.

⁴⁸ Alain Lipietz, 'The Limits of Bank Nationalization in France', in L. Harris, J. Coakley, M. Croasdale, and T. Evans, eds, *New Perspectives on the Financial System*, New York 1988, pp. 389–402.

⁴⁹ See Serge Halimi, Jonathan Michie and Seumas Milne, 'The Mitterand Experience', in J. Michie and J. Grieve Smith, eds, *Unemployment in Europe*, London 1994, pp. 97–115, for a discussion of the development of the Socialists' thinking on this issue from their campaign platform through the early period of the Mitterand government.

beyond this one case. I consider these proposals in terms of both of Banfield's criteria for evaluating voice mechanisms: whether they provide means of increasing the probability of influencing decisions and whether they increase the advantages to be gained from favourable decisions.

3. Influencing Decisions Through Democratic Voice

Beginning in the area of corporate governance, Block has developed a fairly specific proposal for dramatically changing the relevant legal structure. He suggests that the boards of directors of public corporations consist of, for example, 35 per cent employers, 35 per cent asset holders, and 30 per cent others, perhaps including consumers or community representatives. This proposal, as Block points out, would 'initially leave much of the corporation's day-to-day operations unchanged'.⁵⁰ Firms would still have to sell products in competitive markets, and would rely on labour markets in supplying workers. Given the new governance structure, the relationship that the firm has with these markets would undoubtedly evolve over time. Nevertheless, how it does so would remain flexible: Block makes no assumptions as to how operations would be affected by the democratic governance structure. The only certainty is that creating the democratic-voice mechanism would separate the firm's decision making from the influence of the wealthy, in particular, the firms' largest shareholders.

Considering workers' pension funds—the largest saving vehicle in the US, incorporating one-third of the economy's financial assets—Barber and Ghilarducci take an approach similar to that of Block.⁵¹ They propose that the authority of fund participants themselves over the funds' investment decisions be increased substantially. This would be achieved by mandating elected participant representation on corporate pension-fund boards. Under current practice, pension-fund managers and government regulators almost always interpret existing regulations in the most restrictive way, and thereby treat their fiduciary responsibility as equivalent to that for incompetent heirs. That is, all authority rests with the managers, none with the fund participants. Barber and Ghilarducci argue that significant steps toward more democratic practices could be implemented even under existing laws.

A variety of proposals have also been advanced to bring greater accountability to the Federal Reserve system, and thereby weaken its independence from democratic political pressures. One proposal is to institute direct elections of the Boards of Directors of the Federal Reserve Banks in each bank region. At present, the regional bank boards are selected by officers of private member banks of the system and by the Governors of the system in Washington.⁵²

⁵⁰ Fred Block, 'Capitalism Without Class Power', *Politics and Society*, 20, 1992, p. 289.

⁵¹ Randy Barber and Teresa Ghilarducci, 'Pension Funds, Capital Markets, and the Economic Future', in G. Dymski et al, eds, *Transforming the US Financial System*, pp. 287–320.

⁵² A range of proposals is discussed in Dymski et al, eds, *Transforming the US Financial System*. The proposal to directly elect Directors of Federal Reserve Banks is developed in Pollin, 'Public Credit Allocation through the Federal Reserve: Why it is Needed; How it Should Be Done', in G. Dymski et al, eds, *Transforming the US Financial System*, pp. 321–54.

4. Gaining Advantage Through Democratic Voice

However useful on their own terms, none of these proposals to increase democratic-voice mechanisms directly address Banfield's criteria of increasing the advantages to be gained by favourable outcomes. In countries that already have extensive public credit allocation systems or, as with Germany, a voice-dominated private system, democratizing these existing voice mechanisms may itself bring more favourable outcomes. However, within private capital market-based systems such as the US and UK, such democratic interventions would have little impact unless a broad system of public credit allocation was concurrently introduced.

The standard 'market failure' justification for the public credit policies flows from the substantial divergence between the social as opposed to the private costs and benefits of many types of lending flows.⁵³ Thus, for example, the effects on employment and community development of loans to finance low-income housing will be quite different than loans to finance corporate takeovers. But the benefits of the low-income housing loan will not accrue solely, or perhaps even primarily, to the investor undertaking the project or the bank but will be spread widely throughout a community. In such cases, a public authority, representing the larger community, will need to subsidize the housing loan over the takeover loan. A literature which considers many of the practical issues in pursuing such public credit policies has developed in recent years. Let us briefly consider some of these discussions in the areas of pension-fund investing, as well as, more broadly, regulatory, monetary and fiscal policy.

Pension Funds

A fairly extensive literature has developed which recognizes that, in principle, a case for incorporating social costs and benefits of pension-fund investing flows readily from the fact that fund participants—as workers tied to specific communities—are likely to be the beneficiaries of the spill-over employment and community effects of these investments.⁵⁴ At the same time, such efforts also face serious pitfalls. The basic problem is that the full social benefits of a given pension-fund investment are not likely to be captured by the participants of a given fund. Other communities and workers will also likely enjoy benefits, but without having to shoulder any of the corresponding costs. As a result, for the pension-fund participants themselves, the fund earns a lower rate of return than they would have through following orthodox investment criteria. Since the 1970s in the US, many instances have been cited where the funds did indeed earn a lower return or incurred higher risks in supporting investments whose social benefits were diffuse.

These criticisms must, however, be seen within a broader context. First, pension funds managed according to the standards of orthodox finance

⁵³ A much more extensive set of criteria for such interventions, and for state interventions more broadly, are discussed in Chang, *The Political Economy of Industrial Policy*.

⁵⁴ This discussion follows the survey of the literature in Barber and Ghilarducci, 'Pension Funds, Capital Markets, and the Economic Future'.

have themselves performed quite poorly in the 1980s as financial markets became increasingly speculative. According to one study, pension funds earned on average 2.6 per cent less than the average of the Standard and Poor's 500 index, and this before subtracting management fees that averaged 0.5 per cent of assets. Such a performance suggests that the funds should simply fire their managers and purchase an index fund such as that for the Standard and Poor's 500. The problem here is that in so doing, the fund participants, far from increasing their control over the allocation of their own pensions, would then have completely surrendered their authority to the vagaries of the market.

The alternative would be to use policy to create market conditions supportive of social investment criteria. Barber and Ghilarducci point out that, as experience has been gained and when governments have been supportive, many efforts at social investing of pension funds have been successful. To solidify these successes, and to advance similar initiatives toward the construction of a democratic voice-led financial structure, broader supportive measures will be needed in the areas of regulatory, central bank and fiscal policy.⁵⁵

Financial Regulation

Let us consider again the Community Reinvestment Act, as it is one recent regulatory initiative in the US in which something akin to a democratic-voice agenda has at least been put into law, if not practice. One major problem with the CRA is that it applies only to banks. The banks legitimately claim that they are placed at a competitive disadvantage relative to other intermediaries. This disadvantage is then used as one argument for not enforcing the law. A simple but dramatic means of strengthening the CRA would thus be to extend its requirements to all intermediaries—to 'level the playing field upward' for all financial institutions.⁵⁶ As proposed by D'Arista and Schlesinger, such an upward leveling of regulatory requirements could be accomplished fairly readily. The primary legal change would entail a uniform licensing system for all inter-

⁵⁵ Contrasting perspectives on the viability of comparable strategies in the UK are given by Robin Murray, 'Pension Funds and Local Authority Investment', in L. Harris, J. Coakley, M. Croasdale, and T. Evans, eds, *New Perspectives on the Financial System*, New York 1988, pp. 306–24, and Richard Minns, 'Pension Funds: An Alternative View', in Harris et al, eds, *New Perspectives on the Financial System*, pp. 325–44. The experience in Sweden since 1976 with the wage-earner fund proposed by the union economist Rudolph Meidner also offers interesting perspectives on the progressive management of pension funds. However, Meidner's plan was an effort to extend worker ownership and control over the operations of the firm (paralleling the Block proposal in this latter aspect), in addition to influencing the broader composition of investment, the primary concern of social investment strategies in the US. For discussion of the political issues aroused by Meidner's proposal, see Jonas Pontusson, 'Sweden: After the Golden Age', in Anderson and Camiller, *Mapping the West European Left*, pp. 23–54.

⁵⁶ The proposal to 'level the playing field upward' for all financial institutions is presented in Jane W. D'Arista and Tom Schlesinger, 'The Parallel Banking System', in G. Dymski et al, eds, *Transforming the U.S. Financial System*, pp. 157–200. Further background on the evolution of the financial regulatory structure is presented in D'Arista's extensive and important study, *The Evolution of US Finance*, vol. II, Armonk, NY 1994.

mediaries, which would include all institutions that accept deposits from the public and make loans or purchase equity with those funds. All such institutions would then be required to maintain some form of a 'community investment' portfolio.⁵⁷

Such a change would also clearly require a revision of the notion of a 'community portfolio': the proposal would obviously not aim to have 'communities' already favoured with heavy concentrations of financial institutions, such as Wall Street, showered with new lending opportunities while areas with few financial institutions are starved for funds. In keeping with the spirit of the CRA, the principle underlying its broadening would have to be that financial institutions must take into account the social spillover effects of their loan portfolio in order to comply with the terms of their charters. Implementing this idea on a broad scale could perhaps be best accomplished within the framework of central bank policy.

Central Bank Policy

With respect to the Federal Reserve, fairly simple measures could go far to support social criteria for credit allocation and investment, and thereby also complement policies to extend democratic accountability within the central bank. At present, the Fed operates through two basic policy instruments: open-market operations, which is the buying and selling of government securities in 'the open market' to change short-term interest rates; and 'discount-window policy' through which the regional Federal Reserve banks make loans directly to banks seeking additional cash reserves. Both policy instruments are exclusively concerned with short-run movements of interest rates and credit aggregates. And yet, as a result of the experiences over the past twenty years with financial innovation, deregulation and globalization, the Federal Reserve's ability to achieve even their short-term policy aims has diminished.⁵⁸

At the same time, I have argued elsewhere that two relatively simple policy innovations could substantially increase the central bank's ability to influence longer-term credit allocation patterns, including policies targeted at social-lending criteria.⁵⁹ The first policy change would be to increase the role of discount-window lending relative to open market operations. This will give the regional Federal Reserve Banks, each of which operates its own discount window, more direct regulatory authority over the lending activities of private intermediaries, enabling them to promote longer time horizons and financial stability, as well as a set of social-lending criteria flowing from, for example, a targeted pension-fund investment strategy. It will also redistribute Federal Reserve decision-making power downward, creating more effective channels for accountability. The second suggestion is to establish differential asset-reserve requirements for all US intermediaries. Preferred uses of credit, established by the calculation of social

⁵⁷ D'Arista and Schlesinger, 'The Parallel Banking System'.

⁵⁸ On the limited capacity of standard monetary policy tools to achieve their goals see, for example, Benjamin Friedman, 'Lessons of Monetary Policy from the 1980s', *Journal of Economic Perspectives*, vol. 3, 1988, pp. 51-72.

⁵⁹ Pollin, 'Public Credit Allocation through the Federal Reserve'.

costs and benefits of loans, would then become significantly less costly than non-preferred uses of funds. This subsidy for socially desirable loans would then be one simple way to generalize the social-lending criteria embodied in an expanded Community Reinvestment Act or a targeted pension-fund investment strategy.

Securities Transaction Tax

The aim of such a tax would be to reduce speculative financial activity by raising the costs of trading financial assets. This would be done by subjecting all financial asset trades to a small tax. The tax rate would be low enough that it would be negligible in cases where assets were purchased and held for lengthy periods. The burden of the tax would only be felt among those who are frequent traders.

One of the advantages of this proposal is that, even if it failed to significantly reduce speculative trading, it would become a formidable source of government revenue, which could in turn finance, for example, a public investment programme. Baker, Pollin and Schaberg estimate that, given the level of trading in the current US securities markets, a tax of 0.5 per cent on equities which was then scaled down appropriately for all bonds and derivative instruments, would raise roughly \$30 billion a year in revenue, even if trading volume fell by one-half.⁶⁰

Such taxes have operated in many countries, including France, Germany, the Netherlands, and Japan. In recent years, however, they have been largely abandoned, in response to two arguments: that financial markets have become too complex to enable the tax to be imposed equitably across the various markets; and that global financial integration forces countries to minimize taxes, and other costs, to potential investors or else lose those funds to countries with lower taxes. However, neither of these considerations present insurmountable barriers to designing a workable tax. As noted above, the 0.5 per cent tax rate on equities would not be applied uniformly to all markets, but would rather be scaled downward in the bond and derivative markets according to the maturity of various instruments. To discourage investors from leaving the US market, the tax should be levied on all trades made by US taxpayers, regardless of the country in which the trade occurred, just as income tax is levied on all income, not just that earned in the US. Such a tax would of course operate more effectively in conjunction with a similar tax, as proposed by James Tobin, on foreign exchange trading in which all countries cooperate.⁶¹ However, experiences with purely domestic versions of the tax make clear that they can function effectively within this more narrow context, especially in a country such as the US with a deep market for domestic securities.

⁶⁰ Dean Baker, Robert Pollin and Marc Schaberg, 'Main Street vs. Wall Street: Taxing the Big Casino', *The Nation*, 9 May 1994, pp. 622–4.

⁶¹ David Felix develops the basic arguments on behalf of the 'Tobin' foreign exchange trading tax, including the position that its revenues be directed at financing the United Nations. 'The Tobin Tax Proposal: Background, Issues, and Prospects', *Futures*, vol. 27, no. 2 (1995), pp. 195–208.

Are These Proposals Utopian?

The specific policy ideas sketched here are drawn entirely from programmes that have been used, or at least seriously considered, in the US or other advanced capitalist economies. Considered in technical terms, they are therefore feasible in that they do not represent a serious departure from existing institutional or policy arrangements. They are also adaptable to the existing political realities in a country, in that they could be implemented in stages, beginning with the institutional configuration already in place.

At the same time, considered as a whole, there is no doubt that such extensions of democratic voice would entail a substantial downward shift in economic power, and would therefore be resisted by the political and economic elite. In particular, one would expect elite groups to persistently seek to undermine the effectiveness of any such policies once they were enacted into law, as has been done in the US with the Community Reinvestment Act. This raises the issue posed by Coakley and Harris for the UK and Lipietz for France: whether public ownership of financial institutions remains an imperative, not as an end in itself, but as the means of implementing the types of egalitarian reforms outlined here.⁶² We will once again leave aside the political dimensions of that question, though they are obviously of fundamental importance, and turn instead to the implied economic issue: how a voice-dominated financial system would operate under public ownership.

IV. Public Ownership and Credit Policies

I. The Bardhan/Roemer Model of Market Socialism

Bardhan and Roemer have argued that what I am calling a voice-led public credit allocation system can be used as the central organizing institution for a workable market socialist economy.⁶³ Their proposal incorporates levels of public ownership beyond that of the financial sector to include large-scale non-financial enterprises as well. But the general thrust of their proposal brings into focus issues relevant for various types of nationalization strategies. More generally, as I discuss below, their approach can be viewed as one strategy within a range of alternatives for developing a framework of democratic voice in financial systems.

Bardhan and Roemer argue that a market socialist economy is one in which the economy's large-scale productive assets are publicly owned in some fashion. The profits from these enterprises are distributed equally among the public. The fundamental challenge for such an economy is the same as that which was never successfully resolved in the former Communist economies: how to resolve the principal-agent problem between managers as agents and the widely dispersed firm owners—the state and ultimately the citizenry—as principals.

⁶² Jerry Coakley and Laurence Harris, *The City of Capital: London's Role as a Financial Centre*, Oxford 1983; Lipietz, 'The Limits of Bank Nationalization in France'.

⁶³ Bardhan and Roemer, 'Market Socialism'.

Since Bardhan and Roemer view this problem as equivalent to that between owners and managers in corporate capitalism, they argue that its most efficient resolution will emulate the successful resolutions that have occurred in capitalist economies—through a set of voice-led financial institutions with a competitive managerial labour market and clear standards for managerial success. They further argue that resolving the system's incentive problems will establish strong safeguards against what Kornai has termed 'soft budget constraints'—the means through which governments will deviate from established budgetary, tax and pricing policies to bail out inefficient firms rather than allow them to fail.⁶⁴ Bardhan and Roemer devote less attention to the ways in which voice-led financial systems might also effectively resolve macroeconomic coordination and information problems though, as I discuss below, these advantages of a voice-led system should also be transferrable to economies dominated by public ownership.

Bardhan and Roemer have outlined a set of financial institutions which draw heavily from the Japanese Keiretsu system and other existing voice-dominated systems. For example, in their model that is most closely akin to a Keiretsu system, firms are organized as joint-stock companies—owned by their workers, other public companies within their group and the main investment bank which finances the group and oversees its activities. There could also be other subsidiary owners, including pension funds and insurance companies. The state would be the major owner of the banks, pension funds, and insurance companies. In this case there would be several monitors of the firm's activities: the worker-owners, the workers and managers of the other firms in the same industrial group, the managers of the pension funds and insurance companies, and most importantly, the managers of the main bank. As the primary suppliers of funds for the non-financial firms, the bank managers would have responsibility for financing the individual group and maintaining its level of performance. In particular, the shares of the large firms can be sold to the main bank. The main bank will therefore receive information on firm performance based on their own evaluations as well as those of other institutions.

The primary source of external finance in this arrangement would be the banks which are themselves publicly owned. Funds could thus be readily channeled from the state, via the public banks, to the firms. How then could these systems avoid the problem of soft budget constraints? Bardhan and Roemer point to three main safeguards. The most important is the incentive system for managers. Bank managers who are forced to plead with the state for bail-out funds will damage their reputation in the process. Moreover, the state would have to make credible pre-commitments to performance standards, and be prepared to liquidate businesses which fail to meet them. Finally, the economy would be open to international competition.⁶⁵ This will create an external source of accountability for the firms and the system as a whole.

⁶⁴ See for instance Janos Kornai, 'Market Socialism Revisited', in Bardhan and Roemer, *Market, Socialism*, pp. 42–68.

⁶⁵ Though Bardhan and Roemer are not clear on this point, opening an economy to international competition should not be interpreted to imply an endorsement of unfettered free trade. Considering an extreme example, we would not expect an economy operating under socialist precepts to open its markets to goods produced by prison labour.

2. Exit/Voice Finance and Alternative Property Relations

The Bardhan/Roemer proposals are essentially a means of stretching the egalitarian possibilities of voice-dominated financial systems by combining the democratic features of a voice system with an egalitarian redistribution of property rights. The relationship between this proposal and the others we have surveyed is summarized in the Table (p. 61). The rows of the matrix characterize the three types of financial systems: exit-dominated, elite voice-dominated, and democratic-voice systems. The columns characterize predominant property arrangements—private, mixed, and public. Various historical and existing systems are situated along the first two rows. The proposals we have discussed are along the bottom row, since all include a democratic-voice mechanism, but are distinguished by their predominant system of property ownership.

It becomes clear from this figure that the one change for which there is no equivalent experience is the movement down the table toward a democratic-voice mechanism. This raises the question of whether the successes of the elite-voice systems are transferable to democratic-voice systems. At the same time, the proposals represented in the cell which combines democratic voice with predominantly private ownership are designed to be implemented incrementally as a reformist programme within the existing exit- and elite voice-led capitalist systems located in the upper cells of the matrix. Movements toward the Bardhan/Roemer proposals would entail a more substantial transformation relative to the existing capitalist economies, though not necessarily to the former Soviet-type economies. In any case, such movements pose the additional issue of whether combining democratic voice with public ownership would further erode the benefits of the elite-voice systems. These are the issues to which we now turn.

3. Democratic Finance, Public Ownership and Critique of Market Socialism

The question of whether democratic financial systems can retain the efficiency features of the elite-dominated voice systems can be evaluated within a broader and more venerable debate: whether a market economy's sources of efficiency can be replicated within any egalitarian economic arrangement. This question has received considerable attention within debates over the viability of market socialism. Oscar Lange was of course the first to offer a model showing that a market socialist economy could function efficiently. He demonstrated that in an economy with free consumer choice, but where the means of production are publicly owned, the price mechanism could still be deployed for solving the informational problems associated with price formation and resource allocation.⁶⁶

Lange was attacked by Hayek, who held that his model, while internally consistent, nevertheless overlooked the fundamental source of capitalism's efficiency. This was not its ability to allocate resources through competitive price formation, but rather the nature of its property rights

⁶⁶ Oscar Lange, 'On The Economic Theory of Socialism' (1936), in B. Lippincott ed., *On the Economic Theory of Socialism*, Minneapolis 1956.

system. In particular, Hayek held that the system of private property encourages technical progress which, in turn, was the source of capitalism's dynamism.⁶⁷ It has been recently argued, moreover, most carefully by Howard and King, that this Hayekian critique of market socialism in fact parallels Marx's own understanding of the sources of capitalism's dynamism. Howard and King write that:

Disregarding the difference in language, Marx and Hayek are in agreement on two fundamental matters concerning the nature of capitalist social relations. First the strength of capitalism lies in its dynamic transformative power, not its ability to engender allocations which satisfy static utilitarian welfare criteria. Second, capitalism is especially effective in raising productivity.⁶⁸

From this perspective, capitalism engenders efficiency because its system of property relations provides freedom to capitalists to develop new methods of production and discard existing techniques, and, similarly, to deploy and discard employees as needed. Moreover, the system provides a powerful incentive structure for capitalists, by holding out formidable material rewards for those who succeed in raising productivity through innovation, and severe punishments for those who fail.

For Howard and King, it is clear that a market socialist economy cannot allow private individuals this degree of freedom in choosing methods of production and especially in hiring and firing workers. It cannot therefore replicate the basic source of capitalism's efficiency, and will thus inevitably be out-competed by an economy with capitalist private property relations. Howard and King argue that if market socialist economies were able to compete with capitalist economies in terms of innovation and productivity, then they should have been emerging embryonically within contemporary capitalism.

4. How Would a Democratic-Voice System Fare?

Clearly, the types of concerns raised by Howard and King and the related critical literature on market socialism apply most directly to the Bardhan/Roemer version of a democratic-voice financial system, since theirs is explicitly a model of market socialism dominated by public ownership. Nevertheless, the general issues relating to the sources of capitalist efficiency are crucial to all versions of a democratic-voice dominated financial system. The departure point of the various democratic financial arrangements is that they are not relying on the market as a mere computer analogue (as Patnaik uses the term),⁶⁹ guiding price formation and resource allocation. Rather, they are centered around a set of institutional relationships for solving the incentive, coordination and informational problems that result within large-scale enterprises and, more broadly, within modern economies at the macro level, regardless of the property

⁶⁷ F.A. Hayek, 'Socialist Calculation: The Competitive "Solution"', *Economica*, 7, 1940, pp. 125–49, and *The Fatal Conceit*, Chicago 1988.

⁶⁸ Michael Howard and John E. King, 'Is Socialism Feasible? An Analysis in Terms of Historical Materialism', *Review of Political Economy*, vol. 6, no. 2, (1994) p. 143.

⁶⁹ Prabhat Patnaik, *Economics and Egalitarianism*, New Delhi 1991.

forms around which these economies are organized. As such, these voice-dominated systems are able to transcend the criticisms of Lange-type market socialist schemes.⁷⁰

First, as we have seen, the existing elite-voice-dominated financial systems are more efficient than the exit systems in promoting long-term productivity growth, and—focusing primarily now at the macro level which Bardhan and Roemer did not address—in supporting productive investment, reducing financial fragility and mitigating the effects of speculation. That is, elite-voice-led systems do indeed outperform the exit-led systems according to Howard and King's yardstick of productivity and innovation.⁷¹ In addition, because voice-dominated systems have functioned well in various institutional settings, it is fair to say that they have met Howard and King's more stringent test: they have emerged within the interstices of capitalism, and have survived and grown precisely because they outperform exit-dominated financial systems. It is true that part of the basis for their success has been the willingness of the elite class to pursue longer-term 'organizational capabilities' strategies to high performance, thereby foregoing a shorter-term route to rewards through following financial market indicators. This suggests that if the elite classes perceived the short-term gains of a financial market strategy were rising significantly in relative terms, it may become increasingly difficult to maintain an elite consensus around a voice system. On the other hand, were the elite-voice systems to be substantially democratized, one of the premises behind such a transformation would have to be to create a new political coalition committed to nurturing the long-term advantages of a voice model.

Could a democratic-voice model function without relying upon unemployment and allied punishments as sources of efficiency? Several points are relevant here. First, to the extent that the purpose of unemployment is to preserve the capitalists relative bargaining

⁷⁰ Working through a critique of the Arrow-Debreu model of general equilibrium, such an argument can also be derived from Stiglitz's recent book on market socialism (Joseph E. Stiglitz, *Whither Socialism?* Cambridge, Mass. 1994), as is made clear in Roemer's review of this work. John E. Roemer, 'An Anti-Hayekian Manifesto', *NLR*, 211, pp. 112–29.

⁷¹ There is no presumption here as to which route to high productivity is more appropriate for either a technological leader or follower, though it is true that historically, voice-led systems have been associated with late developers, such as Germany, Japan, and South Korea, while the exit-led systems, the US and the UK, began as technological leaders. In *The Political Economy of Industrial Policy*, especially chapter 3, Chang gives several reasons why a state-led industrial policy can be at least as effective in promoting endogenous technical innovation and long-term dynamic efficiencies. Perhaps a more fundamental issue here is that the discussion assumes that productivity gains, without reference to the composition of output, are themselves necessarily desirable. While this is not the case, there is little doubt that what Edward Nell terms a 'transformational growth path'—that is a change in output composition that incorporates the environmental effects of production on social rates of return—is desirable, and that the means to attaining that will entail sustaining both relatively high levels and an efficient allocation of investment resources. Nell, *Transformational Growth and Effective Demand*, London 1992.

power in labour markets, any significant extension of public ownership and democratic-voice should reduce that source of pressure for unemployment. Second, to the extent that unemployment is associated with macroeconomic fluctuations independent of labour market imperatives, we have seen that the voice-dominated financial systems perform better at maintaining a stable macro environment. Operating with a more stable macro economy, the voice-led economies are then better able to effectively utilize the traditional tools of fiscal and monetary policy.

Could the democratic-voice systems also maintain the set of micro-incentives available to an elite-voice system? Bardhan and Roemer suggest that they could, as long as the economy is open to international competition, the government is committed to maintaining clear performance standards and hard budget constraints, and, most importantly, there exists a competitive managerial labour market. However Putterman, and Roland and Sekkat contend that the managerial labour market will not be efficient within a Bardhan/Roemer type public ownership framework, and their points raise concerns about all democratic-voice systems.⁷²

The first argument, emphasized by Putterman, is that citizens in general are too diffuse a group as owners. They will have neither adequate information nor the motivation to serve as effective monitors of managerial performance. While this is a serious concern, it is once again the same problem that exists within a private capital market system. Putterman cites the Jensen-type solution to this problem within a capital market system, that is, the monitoring that occurs via the market for corporate control. But as we have seen, the more efficient and potentially more egalitarian solution is a voice-dominated financial system. Moreover, encouraging strong citizen associations within the voice-dominated system will increase the effectiveness with which citizens monitor managerial performance.

The second concern, stressed by Roland and Sekkat, is that any system dominated by public ownership will have foreclosed the exit option for managers dissatisfied with a career in the public sector. Predominant public ownership will put the state in the position of a monopsonist relative to the managerial labour market, giving the government 'hold-up' power over the careers of managers. This is a strong argument, but it applies fully only to a system with complete public ownership. What their position points toward is the relative merits of arrangements somewhere in the middle cell of the last row of Table 1—that is, a democratic-voice dominated system with both public and private ownership of corporations. This is likely to provide both a favourable environment for innovations in voice-dominated finance while also preventing the state from becoming a monopsonist in the managerial labour market.

⁷² Louis Putterman, 'Incentive Problems Favoring Noncentralized Investment Fund Ownership', Bardham and Roemer, *Market Socialism*, pp. 156–68. Gerard Roland and Khalid Sekkat, 'Market Socialism and the Managerial Labor Market', in Bardham and Roemer, *Market Socialism*, pp. 204–18.

V. Conclusion

Democratic-voice-led financial systems offer a highly promising foundation on which to reconstruct an egalitarian economic policy agenda. Such an approach, first of all, is premised on what Patnaik argues is the fundamental requirement for an egalitarian economy, 'the creation of appropriate institutions for the active participation of the working class in economic and political life'.⁷³ In addition, this approach is highly flexible. It can be developed on the basis of existing institutional arrangements within capitalist economies, and thus, depending on political circumstances, can be implemented in varying increments on the foundation of the existing institutions. Moreover, this policy apparatus can be effectively adapted to diverse property ownership systems, ranging from private-ownership economies such as the contemporary US to predominantly public-ownership systems such as still exist in most of Eastern Europe or as envisaged by Bardhan and Roemer.

Of course, capitalists and their political allies will resist any serious encroachments on their prerogatives in financial markets. Democratic-voice systems will not be implemented on the basis of their compelling logic alone. This is why we have pursued Coakley and Harris's suggestion that public ownership of major financial institutions may be necessary, not as an end in itself, but as the basis for implementing effective democratic credit policies. Even so, in countries such as the US where public ownership of the financial system is not politically feasible, important elements of a democratic-voice agenda are still possible. Programmes such as community reinvestment, the targeting of pension-fund investments, and changing both the operating goals and degree of accountability of the central bank are politically feasible even within the existing US economy and should be primary concerns of progressive movements. In addition, by working to build such policy initiatives within private financial systems, we gain experience and understanding about the limits of reform under private financial systems.

The key to the viability of the democratic-voice approach is that it is able to build upon the solution of elite voice-dominated financial systems to the incentive, coordination and information problems existing in all economies. We saw that the elite voice/bank-based model operates more efficiently than exit-based systems in promoting compatible goals between owners and managers of firms. These features of the elite-voice model should be transferrable to democratic-voice systems.

Much, if not most, economic activity within any version of the democratic-voice model would still be conducted through markets. However, the democratic-voice model is not vulnerable to the legitimate critique of the Langeian market socialist model, that such a model employs markets as a mere computer analogue, neglecting the social relationships underlying them. At the same time, to the extent that the democratic-voice model operates effectively, it should also be able to utilize traditional macro policy tools—indeed, it should be better positioned to use them than more free-market oriented economies—to minimize unemployment.

⁷³ Patnaik, *Economics and Egalitarianism*, p. 33.

More importantly, it should be well positioned to trade off the efficiency 'benefits' of unemployment with alternative sources of efficiency.

Are voice-dominated financial systems viable within increasingly globalized markets?⁷⁴ It is true that advanced capitalist economies with bank-based systems, such as Japan, France, and Germany, have followed the worldwide trend since the 1970s in liberalizing their financial systems. Regulatory reforms in Japan and France have, for example, increased the ability of commercial banks to participate in capital markets. In Germany, where banks have always been active in capital markets, deregulation has endorsed the use of new financial instruments and the participation of foreign banks in domestic capital markets.⁷⁵ In South Korea and other East Asian economies there has been general movement since the 1970s toward interest rate deregulation, securitization of financial markets, and relaxation of regulatory standards.⁷⁶

At the same time, fundamental elements of the bank-based systems have remained intact. For example, close bank-industry relationships, such as the Japanese Keiretsu system, have not eroded, despite security market liberalization. In addition, state involvement in credit allocation remains strong in the bank-based systems—with the exception of Germany, which has never relied on this mechanism. The governments of bank-based systems continue to receive a substantial proportion, if not the majority, of their economies' saving through postal saving systems and similar forms of public intermediation. Given this source of funds, the governments are able to retain considerable influence in credit allocation decisions, which they exercise through their respective planning agencies.⁷⁷ The fact that, over the late 1980s, active markets for corporate control did not develop in the traditional bank-based financial systems indicates that liberalization has not subverted these countries' 'dedicated capital' financial relationships. It is not clear whether these voice-dominated institutional forms will surrender to the pressures of global financial markets over time. For this to happen would require that the continued financial deepening generated through globalization would create ever greater—and finally irresistible—profit opportunities through 'fluid' investment strategies.

In short, we leave as an open question the extent to which globalization represents a threat to the future viability of existing bank-based systems, to say nothing of democratic-voice policies. Nevertheless, the existing Japanese model of a bifurcated system—with an open segment that is free to pursue all market opportunities and a controlled 'dedicated capital' sector—appears to offer the outlines of a solution that is viable both for the existing bank-based systems, and, more importantly, for the develop-

⁷⁴ The following discussion has benefited greatly from preliminary work on this question by Ilene Gabel.

⁷⁵ Itzhak Swary and Barry Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads*, Cambridge, Mass. 1992, passim.

⁷⁶ World Bank, *The East Asian Miracle: Economic Growth and Public Policy*, New York 1993, pp. 339–41.

⁷⁷ Ilene Gabel, 'Saving and the Financing of Productive Investment: The Importance of National Financial Complexes,' in R. Pollin, ed., *The Macroeconomics of Finance, Saving and Investment*, Ann Arbor 1996 (forthcoming).

ment of democratic-voice policies that a progressive movement would want to pursue. Beyond this, the issue must be evaluated in political terms. If globalization is indeed destructive of egalitarianism, then progressive political movements will have to develop economic programmes that can neutralize these forces while simultaneously advancing egalitarian economic arrangements that promote both micro efficiency and macro stability. My contention is that an approach guided by democratic-voice financial policies can provide the foundation for such an economic programme.

Financial Systems and Forms of Property

<i>Predominant Financial Institutional Framework</i>	<i>Predominant Ownership Form</i>		
	<i>Private</i>	<i>Mixed</i>	<i>Public</i>
<i>Exit</i>	US UK—1980s	UK—1960s–70s (primary public ownership of non- financial firms)	—
<i>Elite Voice</i>	Japan, Germany	France, S. Korea (primarily public ownership of financial firms)	Former USSR
<i>Democratic Voice</i>	Proposals for US on community reinvestment, pension funds, Federal Reserve, security transaction taxes	Coakley/Harris Proposal	Bardhan/Roemer Proposal