Democracy, Law and Global Finance: An example of a research agenda for a new practice of law and economics

Tamara Lothian, Columbia Law School
Democracy, Law and Global Finance: An example of a research agenda for a new practice of law and economics

Tamara Lothian

**Table of Contents**

Introduction: nature and scope of the project................................................................. 2
The approach to law and finance .................................................................................. 3
Structure and democracy: the theoretical horizon ....................................................... 3

Research agenda and plan of execution ..................................................................... 4

A comparative legal-institutional map and a toolkit of broad applications ................... 5
  Comparative legal-institutional mapping .................................................................... 5
  US and Brazilian examples ....................................................................................... 5
  Chinese examples .................................................................................................... 6
  European examples .................................................................................................. 6
  Main dimensions of the comparative research .......................................................... 7
  The legal-institutional toolbox .................................................................................. 7

Methods and data......................................................................................................... 9

Appendix 1 .................................................................................................................... 10
Appendix 2 .................................................................................................................. 11
Appendix 3 .................................................................................................................. 12
Introduction: nature and scope of the project

Finance has become more a problem than a solution to what the world most wants: socially inclusive economic growth. It has become a source of crises that threaten the development of the real economy. It has escaped accountability to democratic institutions and often helped, instead, to influence and corrupt them. Its potential to contribute to broad-based opportunity-expanding growth has been largely and massively squandered.

In this piece and in a developing body of writing, I seek to understand not only how this failure manifests itself in some of the major countries and regions of the world, but also, how it can be corrected. One of the positive programmatic outcomes should be a toolbox of legal-institutional arrangements to use and organize finance in the service of socially inclusive growth.

These innovations do not amount to a confining, universal blueprint. They are nevertheless applicable, with suitable adjustments, to a wide range of contemporary economies. Moreover, we can develop them with conceptual and institutional materials that are already at hand, in contemporary experience. To identify these resources for legal and institutional innovation, through comparative analysis, thus forms another goal of the intellectual agenda.

My method of analysis gives pride of place to institutional alternatives and innovations, expressed in the detailed materials of law. It is comparative law turned into a practice of micro-institutional analysis. We expand our sense of institutional alternatives as we begin to grasp the institutional variations already at hand. From small variations, we may begin to imagine larger variations, informed and inspired by a progressive programmatic imagination.

The intellectual and policy response to the crisis in its American and European epicenters has almost entirely suppressed discussion of two themes of immense importance: the link between redistribution and recovery and the connection of finance to the real economy. In the face of regressive redistribution, mass consumption came to rely increasingly on an extraordinary expansion of household debt (made possible in part by overvaluation of the housing stock as collateral). Finance increased its size (as a proportion of GDP and as a drain on talent) while weakening rather than strengthening its service to the productive agenda of society.

My analysis recovers these suppressed themes, in part by relating them to a third theme: the deficit of democratic accountability that lies at the root of many of these problems. Instead of being made accountable to democratic institutions, finance in the most advanced economies has gained inordinate political influence and become the star example of “capture” of government by powerful private interests. Corruption becomes then simply the most salient aspect of a whole system of collusion that undermines the vitality of democratic institutions, even as it squanders the potential for reform presented by the crisis.

Such an account places familiar issues of corruption in a broader and more revealing, institutional context. It suggests both how and why transparency and accountability of finance within the economy require changes beyond the economy: in the constitutional organization of the state; in the social organization of production; in the institutionalized organization of financial markets and their relation to the real economy.
The approach to law and finance

This project builds on earlier work in which we develop a new perspective on law and finance in the context of a broader view of the relation of finance to the real economy. Five ideas are central to this conception. These ideas may be summarized in the following manner:

1. The market economy does not have a single natural and necessary legal-institutional form. The form it now takes in the rich North Atlantic economies is inadequate to ensure the achievement of the widely professed goal of socially inclusive growth except when and where this goal has been accomplished by a long prior history of efforts to broaden economic and educational opportunity (e.g. the pre-history of Scandinavian social democracy). The institutional reorganization of finance and of its relation to the real economy should be understood as part of the larger project of reimagining and remaking the market economy.

2. Under present arrangements, finance readily becomes the master rather than the servant of the real economy and lays itself open to recurrent booms and busts.

3. The present arrangements can be reformed in ways that more effectively put finance at the service of the productive agenda of society.

4. The regulation of finance can and should be designed as an initial move in such an institutional reshaping.

5. The fifth idea is that neoclassical and Keynesian conceptions are inadequate guides to the execution of this task. We can find in law and legal thought many of the intellectual and practical tools that we need. The reason is straightforward. The ways of organizing a market economy now on offer in the world exist as a legal repertory; the detailed institutional alternatives exist as legal alternatives. Thus, the expansion of the repertory must take the form of institutional alternatives that are alternatives expressed in law. Existing and historical variations in the organization of the market economy, and in the relation of finance to the real economy, in particular, provide possible points of departure for the design and construction of the kinds of arrangements we need to secure socially inclusive growth.

Further development, contextualization and support for these ideas may be found in the body of writings listed in Appendix II.

Structure and democracy: the theoretical horizon

The basic thesis explored in this project is the centrality of structure and structural variation. By structure, I mean the basic arrangements and ideas that shape different areas of social organization. By structural alternatives, I mean largely institutional alternatives and alternative ways of thinking about institutions.

The idea of structure in social life has traditionally been associated with the idea of a blueprint, ether a universal or local blueprint. But this is association is unnecessary. Structural alternatives do not come as
pre-packaged sets of ideas and arrangements. Programmatic thinking does not involve pre-defining all possible worlds and trajectories of reform. What matters is the direction and the first steps, given the material at hand.

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

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

Two main corollaries flow from this idea. The first corollary is that structural understanding and reform is path dependent. It depends on the existing repertory of institutional ideas already established, either in our own experience, or in experience known to us, whether through contemporary or historical knowledge. These materials serve as points of departure for the development of programmatic proposals. The repertory of institutional alternatives develops through recombination and analogical extension.

The second corollary is that there needs to be a method, a practice or a process – experimentally to advance and reconstruct such alternatives, given the absence of a blueprint. That method is democracy.

For more background on the distinctive character of this perspective and the research agenda informed by this perspective, please see Appendix I.

**Research agenda and plan of execution**

Points of departure: three sets of problems

I organize the study around three sets of problems:

1. The problem of instability: how the present arrangements governing finance and its relation to the real economy open the way to crises damaging to the real economy;

2. The problem of accountability of finance to democracy: how the present arrangements fail to make finance accountable to democratic institutions and allow it to secure dangerous influence;

3. The problem of opportunity: how present arrangements either contribute to or detract from socially inclusive economic growth. We are especially interested in forms of market organization and finance that expand access to resources and opportunities for productive activity.
A comparative legal-institutional map and a toolkit of broad applications

A research agenda exploring these issues in empirical context would have two ambitions.

1. The first task is to draw a comparative legal-institutional map of how the three sets of problems manifest themselves – and of what resources are available for their solution in three major regions of the world: the North Atlantic (US and Europe); East Asia, and South America.

2. The second task is to develop an elementary toolbox of legal-institutional arrangements that, across a broad range of societies, help address these problems. The object is not to design a uniform blueprint: it is to identify instruments that, with adjustments, would be likely to prove useful in a many settings.

I discuss each task below.

Comparative legal-institutional mapping

The first task is to perform a comparative study, at the level of significant legal and institutional detail, of the way the three problems described above present themselves in certain regions and countries of the world, and of the distinctive resources available in those countries to solve the problems.

This task is best understood through a series of examples. I include below examples drawn from the US, Brazil, China and Europe. These countries represent a small, but important subset of the countries and regions to be explored in the course of this research project.¹

US and Brazilian examples

In the United States, the problems -- especially the problem of the inadequate democratic accountability of finance -- result from the partial hollowing out of the New Deal arrangements: the weakening of regulatory vigilance, the turn to regulatory dualism, the perversion of the New Deal GSEs, the hypertrophy of finance to the prejudice of financial deepening, and the immense political influence that finance has acquired over the Executive and the Legislative branches as well as over the central bank.

The resulting system amounts to an ad hoc compromise between the New Deal design and the system preached by market fundamentalism through theories such as the efficient market hypothesis, "rational expectations" and real business cycle theory.

This gingerbread structure forms a large part of the causal background to the crisis and helps explain the severity of instability resulting from finance, the lack of democratic accountability of finance (as well as

¹ Depending on the amount of funding secured, the project will consider as many as seven different countries: US, Germany, Sweden, UK, China, India and Brazil. These countries have been chosen for reasons of size, significance (to the global economy) and diversity. The selection includes some of the most important countries in the most important regions of the global economy. They also represent a wide range of legal, institutional and financial circumstance and response, thus providing us with the materials we need to draw our comparative legal-institutional map and toolkit of broad application.
its inordinate political influence) and the failure to harness finance to the cause of socially inclusive growth: the three problems this study chiefly addresses.

Yet the United States also counts on remarkable resources with which to begin solving these problems. Among the institutional resources is the remarkable decentralized network of local banks. Among the intellectual resources is the tradition of populism or progressivism in the domain of finance, represented by jurists like Brandeis and Douglas.

In Brazil, the problems take a different form. Two connected problems have overriding significance. On one side, there is dualism in the credit markets. A small number of well-connected big firms get highly subsidized credit while everyone else pays very high rates of interest. The capital for the subsidized loans is largely financed by payroll charges. On the other side, to the extent that credit is democratized, access to it is broadened for consumption more than for production. The multitude of small and medium-sized firms are starved of credit and pushed back to a technological-organizational rearguard.

An important institutional resource is the large governmentally owned and directed banks. They are able to make up for downswings in credit in times of financial instability. But the value of this resource is compromised because the credit these public banks offered flows through the channels of dualism in the credit market, and thus reinforces preexisting inequities. An intellectual resource lies in the traditions of economic thinking hostile to the priority accorded to winning financial confidence at any cost.

**Chinese examples**

It is commonly believed that China must shift its growth model to a greater emphasis on production for the internal market. Such a shift is no mere reallocation of resources. It requires massive redistribution among classes, regions and sectors, challenging the limited capabilities of an authoritarian political system. Moreover, it has an important financial component.

Today, China’s financial organizations — its governmentally controlled banks — are used chiefly to subsidize, through sweetheart credit deals, the governmentally controlled enterprises. Local governments and small and medium-size producers find themselves compelled to resort to a vast shadow banking system at ruinous rates of interest.

It is our intention to explore how our themes of financial deepening and of broader opportunity apply to a Chinese context in which the constraints on democratic accountability are likely to remain severe.

**European examples**

The social-market model of Germany and the inclusive social democracy of Sweden provide a third set of experiences for our comparative institutional analysis. These countries have proved successful in combining continuing economic success with a higher level of social solidarity and cohesion. They have avoided the control of public policy by financial interests, and generally succeeded in subordinating the predatory forms of capitalism to the productive forms. Above all, they have favored a high level of investment in people, made possible by a high tax take.
Nevertheless, the range of experimentation in the creation of new forms of production and exchange and new ways of enlisting finance in the service of the real economy remains very limited. Politics has not “heated up” except on the right. Democracy remains, for the most part, an organized conflict over distributive shares rather than a collective instrument for the creation of the new.

In our study of these countries, we will attempt, above all, to distinguish the myth from the reality – i.e. the extent to which these social democratic countries provide sufficient points of departure for designing new institutional forms, capable of reconciling finance, democracy and inclusive growth.

Main dimensions of the comparative research

It is important to emphasize that this is not an encyclopedic research project. It will be a highly selective comparative inquiry, with the selection of material guided by the criterion of which existing variations in the world are useful to the production of new institutional variations, especially variations described in the toolbox below.

In other words, the criteria for selective research will be the forms and variations potentially useful for development of the material described in the toolbox.

For this purpose, the team will conduct three different types of research:

1. Review of the relevant academic literature
2. Conversations and interviews with entrepreneurs, government officials (including central banks), market participants and legal practitioners in each of the countries and regions studied
3. Review of publicly available material provided by public and private research institutes, including the research institutes of major national, regional and multilateral financial institutions involved in the countries and regions studied

A roadmap for the organization of the comparative research and analysis is provided in Appendix II.

The legal-institutional toolbox

The second task of the project is to help identify legal-institutional arrangements or innovations that are promising instruments for the solution to the problems we address across a broad range of contemporary societies.

Take, for example, a worldwide problem: in every country of the world the vast majority of jobs and output is created by small and medium-size enterprises (SMEs). And in all but a small handful of economies (for example, Germany), the vast majority of SMEs have extremely limited access to finance. The manifestation of the problem takes different forms in different regions and countries. But, to a surprising extent, the problems are largely the same. SMEs have difficulty gaining access to credit in each major region of the world economy, from Europe (especially the peripheral European countries) to the US, China and Brazil.
Or, from a different direction, take the problem of the export-led growth model favored by China and other leading emerging market countries. To move away from this model of growth, China and other countries would need to redirect resources to local consumption. But to do this requires financial deepening, and this doesn’t exist. In China and elsewhere, the existing state-owned banks channel funding to the large, state-owned enterprises at the heart of the existing, export-led model of growth. All other producers and entrepreneurs are forced to resort to the usurious alternatives of shadow banking.

The working assumption of the idea of such a toolbox is that, although there is no universal institutional blueprint, the solutions are not just local. The problems and solutions explored in this project apply, increasingly, to every country and region in the world. Thus, the execution of this second task proceeds by a method different from the regional or national focus of the legal-institutional mapping that represents the first task of the project.

These legal-institutional tools fall into seven main categories.

1. The discouragement or outright prohibition of financial products and activities not plausibly related to the expansion of output and the enhancement of productivity in the real economy
   
   Example(s): the ban on short-selling of securities adopted by both US and European governments during the recent crisis; the distinction between hedging and speculative transactions adopted in many different tax and regulatory regimes, accompanied by outright bans (in some cases) and by tax and regulatory incentives and disincentives in others; the restriction on proprietary trading among federally-insured depositary institutions in the US, under the present Dodd-Frank regime and in the earlier Glass-Steagall regime

2. The mobilization of the dormant productive potential of saving (accumulated for example in pension systems): new arrangements to channel long-term saving into long-term productive investment

   Example(s): the creation of the secondary mortgage market in the US, first through the GSEs directly, and then through securitization sponsored and organized by the GSEs; the creation of long-term funding and hedging sources for housing and agriculture in countries and markets around the world; the creation of state-owned banks, development banks and public-private investment funds to channel long-term capital to areas of strategic importance to the national economy (including small and medium-size enterprises)

3. Governmental action to mimic the work of private venture capital

   Example(s): the creation of state-owned banks, development banks (Brazil’s BNDES is the pre-eminent example here), public-private investment funds and tax and regulatory incentives to fund start-ups, spin-offs and other forms of technological and/or organizational innovation

4. The development of ways to make the tools of sophisticated finance accessible to local banks and to the producers they serve
Example(s): the creation of exchange-traded commodity futures in the US and in Brazil; government-sponsored insurance, securitization and secondary mortgage markets in the US and in Latin America; the popularization of options and hedges against the combination of climate and price risk in agriculture the creation of inflation-indexed mortgage contracts and securities in the US and in Latin America

5. The legal and constitutional innovations that would make finance more accountable to democratic institutions and to popular interests

Example(s): changes in the legal organization and governance of monetary and regulatory authorities (e.g., broadening the mandate of central banks to include accelerated growth and employment as well as price stability; public rather than corporate appointment of central bank directors); increased transparency and accountability of monetary and financial authorities to democratically-elected government officials and representatives of civil society; creation of intermediate bodies to oversee – and provide guidance for - bailouts, bankruptcies and restructurings – especially in the context of crisis and with the assistance of government funding, subsidies and/or credit guarantees.

6. Changes in the international monetary arrangements and in the supra-national or regional regulation of finance that would be hospitable to institutional experimentation and legal innovation addressed by the previous five categories

7. Reform of the WTO treaties in ways intended to distinguish more clearly an advance in economic openness from attempts to impose on trading partners a uniform institutional blueprint.

Methods and data

Method: comparative institutionally-oriented legal and economic analysis

Data: publicly-available information produced by government, academic and policy-based research institutes; interviews with people with intimate familiarity with the different economies and legal systems studied in connection with the comparative case studies. Collaborators in the different countries and regions studied will help coordinate research and interviews with local and regional monetary and financial authorities.

In addition, the core team of researchers and advisors will supplement traditional sources of scholarship and data with materials and interviews provided by affiliated scholars, research organizations, NGOs, and professional organizations (including, for example, both global and local law firms).
Appendix I

The distinctive character of the structural perspective informing this research initiative

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

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

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

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

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

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

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

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

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

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

Appendix II

Roadmap for the organization of comparative research and analysis

• Service to the real economy
  o Private banks and their practices
  o Shadow banking and the development of financial products outside the banking system
  o State and development banks
  o The capital markets (including the secondary mortgage markets)
  o The pension systems, both defined-benefit and defined-contribution
  o Central Banks
  o The regulation of financial activity and organizations

• Relation to democracy
  o The influence of finance capital and its power to capture the state apparatus
  o The two ways in which the state controls finance: (a) regulation of private activity; and (b) use of state-controlled financial organizations
  o The insufficiency of these ways, and the need for a type of legislation and policy-making that reshapes the conditions and fors of access to capital; innovation in property regimes
  o The ancillary role of finance; the political conditions and the legal-institutional devices by which finance might come to be cast in this ancillary role.

• Democratization of opportunity
  o The basic distinction between greater equality (of opportunity) through compensatory redistribution by tax and transfer and greater equality through organized broadening of economic and educational opportunity.
  o The dependence of such broadening on institutional innovation, including institutional
innovation in property regimes.

- The post-Fordist transition as an opportunity; the path of least resistance in the post-Fordist opportunity and alternatives to it.
- The specific place of finance in such alternatives

Appendix III

References


FSA (2009), The Turner Review: A Regulatory Response to the Global Banking Crisis, March.


______ (1995), The Criticism of the Third-World Debt and the Revision of Legal Doctrine, 13 Wis. Intl L.J. 422


Sabel, C. F., 2011, Minimalism and Experimentalism in the Administrative State, *Georgetown Law Review, Volume 100, Number 1*


_____ (2010), Constitutionalizing an Overlapping Consensus: The ECJ and the Emergence of a Coordinate Constitutional Order (with Oliver Gerstenberg), *European Law Journal, Volume 16, issue 5*.

_________ (2006), Bootstrapping Development: Rethinking the Role of Public Intervention in Promoting Growth

_________ (2005), Global Democracy (with Joshua Cohen), NYU Journal of International Law and Politics, vol. 37


_________ (2009), Rethinking Macroeconomics, Capitalism and Society: Vol 4: Iss. 3.

_________ (2008), Boom, Bust and Recovery in the World Economy, Project Syndicate


