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WALL STREET CAPITALISM AS "THE MODEL" FOR MARKET ECONOMIES

Abstract. *Throughout much of the world today, American-style Wall Street capitalism is taken as "the model" for a private property market economy. Yet, the Crisis of 2008 has caused some rethinking. This paper argues that far from being "the model," Wall Street capitalism institutionalizes irresponsibility, whereas markets are supposed to connect actions and the responsibility (positive or negative) for those actions. The mother of all the disconnects between action and responsibility is the absentee ownership of business corporations through the stock market. The basic solution is to re-constitute the corporation so that the "human association which in fact produces and distributes wealth" becomes the "association recognised by the law" as being the legal corporation.*

Keywords: *Wall Street, absentee ownership, corporate irresponsibility, workplace democracy*

Introduction

Throughout much of the transition debate in the post-socialist countries, there was an implicit or explicit assumption that American-style Wall Street capitalism was "the model" for an advanced private property market economy. Even in the former Yugoslavia, it was said that "people had lost the will to be different; they just wanted to be normal" where "normal" was given a Made-in-USA definition.

Today, this assumption continues to inform and shape public debate around the world. For instance, the debate about globalization often is just a debate about "Americanization." An idealized version of American-style capitalism is touted as *the* model in the "science of economics" as well as in the "scientific theory of finance." In the mass media of America and increasingly around the world, programs about "business" are in fact about the Wall Streets of the world ("Isn't that what business is about?"), not about

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business enterprises. Problems in the American economy are seen as just temporary bumps in the road while problems in other market economies are seen as structural flaws that can only be resolved by moving closer to the American model.

This often unexamined assumption about the American model has been surprisingly resistant to contrary factual evidence such as:

- the slow deindustrialization of the United States (off-shoring of industrial jobs) in favor of the FIRE (finance, insurance, and real estate) sectors,
- the economic devastation of regions of the country,
- the continuing demolition of the middle-class, and
- the historic increases in wealth and income inequality (Stiglitz, 2012).

The continuing financial collapse of 2008, which caused trillions of dollars of damages to most everyone but the Wall Street elites (the "1%"), will perhaps lead to some hesitation in the reflex to evoke "the American model"–if not to some more fundamental rethinking of the issues. Perhaps the Occupy Wall Street movements around the world are the beginning of such a rethinking.

In any case, our purpose here is such a rethinking by going back to some of the basic principles that are supposed to be exemplified in a market economy.

The Market Principle of Responsibility

Markets are supposed to enforce a certain link between beneficial actions and rewards as well as between damaging actions and paying the costs of those actions. In short, markets are supposed to institutionalize the connection between actions and bearing the responsibility for those actions. When the connection breaks down ("externalities" in the language of economics), then markets malfunction.

Yet over the last century, there have been innovations, particularly in the type of market economy loosely identified as "American-style capitalism," that have systematically institutionalized a 'disconnect' between actions and bearing the consequences of those actions. The irony is that these innovations are not seen as some non-market interventions corrupting the market principle of connecting actions and responsibility; they have been seen as the creation of new "markets" heralded as "improvements" and "advances" in market economies. In the eyes of American leaders and pundits (and their acolytes around the world), these institutional innovations are supposed to be the envy of the world.

Institutionalized Irresponsibility in "Advanced" Financial Markets

The continuing American economic crisis of 2008 was due in large part to a new set of financial instruments (derivatives) and the markets in those instruments. Derivatives were widely touted as innovative financial instruments that "could" be used to hedge risk in new ways. Of course, by the same token, derivative markets could be used to greatly increase risks (and rewards). As it turned out, the explosive combination of secondary markets in junk loans and derivatives markets, after creating enormous profits for the 1%, eventually created trillions of dollars of losses spread over the whole population ("99%"), a population that had little or no idea of what a derivative was and certainly had no responsibility for these Wall Street "innovations."

For example, the creation of secondary markets in mortgages allows lenders to make junk mortgages and then to pass off the dubious debt to others who lacked the local knowledge to judge the quality of the loans. At first the problems (called "moral hazard" and "adverse selection" problems in the economics of asymmetric information (Stiglitz, 2002)) created by secondary markets in mortgages were relatively small and manageable. But then derivative instruments were developed to "slice and dice" the mortgages into new instruments that could be sold as top-quality AAA securities to all varieties of institutional funds. This greatly expanded the original institutionalized irresponsibility of passing off bad mortgages to uninformed buyers so that the resulting boom reached the level of systemic risk that sooner or later would and did crash the system. Yet those whose irresponsible actions in creating these new "advanced" markets bore little of the costs of their actions. In fact, they reaped huge rewards and managed to socialize the losses.

The root of the problem cannot be solved by tweaking regulations (and even that has been stymied by the influence of Wall Street in Washington). The basic problem goes back to the violation of the most fundamental norm of a market economy, the connection between actions and bearing the responsibility for the actions.

The "Model" of the Absentee-Owned Publicly-Traded Corporation

But this recent crisis is only a surface tsunami in comparison with slower and longer term tectonic shifts in the form of the large corporation due to Wall Street. The *mother of all disconnects* in the American-style market economy is the absentee-owned corporation created by the public trading of the equity shares, i.e., by the set of market institutions collectively called "Wall Street." The creation of public markets in corporate ownership shares was also seen as a great innovation, improvement, and advance in a market economy in the late 19th and early 20th centuries. In the Anglo-Saxon model, "the Stock Exchange is not the appendix or gall bladder of the body economic, but its very heart." (Dore, 1987: 118)

Yet these "new markets" created the most fundamental violation of the market principle of linking actions and their consequences, the violation that Berle and Means (1932) famously characterized as the separation of ownership and control. On a grand scale, corporate executives could not on the basis of their ownership but on the sole basis of their organizational role (like the *nomenklatura* of communism), make decisions that directly affected the people working in the companies (and indirectly their communities) without any responsibility mechanism to hold the decision-makers accountable. At least in a political democracy, there is *in theory* the responsibility mechanism of the voters "throwing the bums out." But an absentee-owned company is not even an economic or workplace democracy in theory.

> *The manager in industry is not like the Minister in politics: he is not chosen by or responsible to the workers in the industry, but chosen by and responsible to partners and directors or some other autocratic authority. Instead of the manager being the Minister or servant and the men the ultimate masters, the men are the servants and the manager and the external power behind him the master. Thus, while our governmental organisation is democratic in theory, and by the extension of education is continually becoming more so in practice, our industrial organisation is built upon a different basis." (*Zimmern, 1918: 263*)*

The people working in the large corporations, who are the people actually governed by the managers and who primarily bear the brunt of the decisions, have no vote in the matter.

And the so-called "owners" (the far-flung shareholders) have been so atomized by the wide distribution of shares by Wall Street that the usual difficulty of organizing collective action across the widespread shareholders prevents any effective use their voting power. No one buys shares on Wall Street thinking they will have any real influence on management; the shareholders are in fact only passive investors like bondholders. As pointed out by John Maynard Keynes:

> *The divorce between ownership and the real responsibility of management is serious within a country when, as a result of joint-stock enterprise, ownership is broken up between innumerable individuals who buy their interest today and sell it tomorrow and lack altogether both*

> *knowledge and responsibility towards what they momentarily own. (*Keynes, 1933: 235-6*)*

Albert Hirschman (1970) has made the well-known distinction between two logics: the logic of exit exemplified by markets, and the logic of commitment, loyalty, and voice which might be exemplified by organizations. The point is that we now have a whole "science of economics" that just assumes without second thought that the logic of exit is the only logic.

> *The economist tends naturally to think that his mechanism [exit] is far more efficient and is in fact the only one to be taken seriously. (*Hirschman, 1970: 16*)*

For instance, under the exit-oriented logic all labor questions are "labor market" questions while under the alternative commitment-oriented logic (e.g., in a Japanese-style firm), a labor question is a "human relations" or "human resources" question.[1]

There is an almost automatic reflex that mobility, liquidity, and the absence of frictions are to be preferred over immobility, illiquidity, and the presence of frictions. But the point is that in organizations where the logic of commitment comes into play, then the mobility, liquidity, and frictionless nature of markets may well have a negative effect.

For instance, Keynes was much concerned with the adverse effects of the stock exchange on real investment and enterprise. Investment in productive enterprise is largely irrevocable, and the management of enterprise requires a long term commitment and the application of "intelligence to defeat the forces of time and ignorance of the future...." (Keynes, 1936: 157) But when investment is securitized as a marketable asset on the stock exchange, then it

> *is as though a farmer, having tapped his barometer after breakfast, could decide to remove his capital from the farming business between 10 and 11 in the morning and reconsider whether he should return to it later in the week." (*Keynes, 1936: 151*)*

The stock exchange panders to the "fetish of liquidity" and thus continually undermines the bonds of long-term commitment that are so important to problem-solving and productive enterprise. Keynes, of course, wrote

[1] *For instance, the advice of the World Bank to developing countries about labor is in the "labor markets" topic area (see World Bank (2012)); there is no "human resources" topic area. But for its own staff within the World Bank, there is a Human Resources Vice President but no "Labor Market Vice President." Thus the Bank looks outward through an exit-oriented lens and inward through a commitment-oriented lens.*

this long before today's ultra-short-termism with quarterly reports, stock options, and computerized trading.

One way to make these points using a language of efficiency is to contrast the notion of X-efficiency (Leibenstein, 1966) with the usual notion of allocative efficiency. One way to abstractly characterize the difference between the two notions of efficiency is based on the question of the whether the characteristics of a productive factor are fixed or variable. If the characteristics are fixed, then it is only a matter of allocating the factor or resource to the most highly valued use—which gives rise to the notion of allocative efficiency. But if the characteristics of the factor are quite dependent on a myriad of organizational factors, then it is a question of getting the most productivity out of the factor in the given use. Since the principal "factor" with variable characteristics are the people working in an enterprise, the "X" in X-efficiency is essentially "effort." (see Ellerman, 2005a) And since sustained effort is largely a function of commitment to and identification with the enterprise, the logic of exit may well be singularly *inefficient* in terms of effort-efficiency.

In the post-war era, the large Japanese firms have perhaps gone the furthest to develop the organizational logic of commitment and to contrast it with the market logic of exit. For instance, to one trained to think in terms of the logic of exit, any immobilities, rigidities, or barriers to exit would just seem inefficient and irrational. But Japanese economists have evoked the example of useful barriers to exit as in the practice of a captain being expected to go down with his ship.

> *The way in which underpayment of wages in the early years of service and the acquisition of firm-specific skills create barriers to exit is obvious. These exit barriers perform several important functions for the firm as an organizational entity. The first is the incentive function whereby the interests of the firm and the interests of the individual are linked. Unable easily to exit, people can only protect their interests by working to ensure that the firm prospers. ... The interlinking of interests means that when crisis looms, efforts are redoubled. The option of leaving the sinking ship is not freely available, either to the crew or the captain. (*Kagono and Kobayashi, 1994: 94*)*

Barriers to exit can enhance identification and thus X-efficiency. As the scholars of Japanese industry, Ronald Dore and Hugh Whittaker, put it:

> *Many of the investments made by employees and the assets they have developed over the long term are realizable only within the firm, and these assets would not be fully appreciated in the market place. Hence*

> *there is greater commitment, though not necessarily happy, satisfied commitment. Where the 'logic of exit' prevails, however, the freedom of exit of uncommitted shareholders, and the insecurity thereby induced in managers by frequent takeovers, has a knock-on effect to reduce commitment, as much on the part of senior managers as on rank and file employees. (*Dore and Whittaker, 1994: 9*)*

In Japan the takeover market is virtually non-existent and »It's not just that the labour market for executive talent is imperfect: over large areas of the economy it just does not exist.« (Dore, 1994: 380)

During the last quarter of the twentieth century the township-village enterprises (TVEs) have been a driving part in the remarkable Chinese transition. But their success has been something of a mystery to the orthodox economic viewpoint—lack of conventional ownership and lack of labor market flexibility. The reason is that the TVEs exemplified the logic of commitment. The management identified with the staff since they had to provide jobs and related services to the people of the township or village, and the workers identified with the firm since that was their one chance for a good job (the Chinese government tried to prevent free mobility). The loss in allocative efficiency due to factor immobility seems to have been more than counterbalanced by the increase in X-efficiency since the Chinese growth episode over that quarter century was the largest in recorded history.

Moreover, as Ronald Dore points out concerning the decline of the British economy:

> *Best and Humphries (1983) suggest that most shareholdings were of the 'committed' kind before the end of the nineteenth century, and that it was the development of the 'efficient' stock market without trust and commitment—particularly the nature of the new issues market—and the failure to create investment banks as a substitute, which was a contributing factor in Britain's industrial decline. (*Dore, 1987: 111*)*

But such historical arguments have little effect on the quasi-religious commitment to the Wall-Street version of a private enterprise market economy. Anyone who points out the deleterious effects of Wall Street (or the "City" in London) on the commitment to and responsibility of enterprises is 'anti-market' at the very least, if not some kind of crypto-communist.

Even today, "Wall Street" is supposed to be the envy of the world as was recently evidenced by the Western advisors to the post-socialist countries who imposed voucher privatization to "jump-start" little Wall Streets and to promote the publicly-traded and thus absentee-owned form of the corporation (see Ellerman, 2003). Of all the institutions of American-style capitalism, surely Wall Street has the most totemic and almost religious significance. The Wall Street mentality that was and, to a significant extent, still is found in the post-socialist countries is reminiscent of the cargo cults that sprung up in the South Pacific area after World War II.[2] During the War, many of the glories of civilization were brought to the people in the southern Pacific by "great birds from Heaven" that landed at the new airbases and refueling stations in the region. After the War, the great birds flew back to Heaven. The people started "cargo cults" to build mock runways and wooden airplanes in an attempt to coax the great birds full of cargo to return from Heaven.

During the transition, post-socialist countries, with hardly a banking system worthy of the name, nonetheless opened up Hollywood storefront "stock exchanges" to supposedly kick-start a market economy.[3] Government officials in East Europe, the former Soviet Union, and even Mongolia proudly showed the mock stock exchanges, complete with computers screens and "Big Boards," to Western delegations (with enthusiastic coverage from the Western business press) in the hope that finally the glories of a private enterprise economy would descend upon them from Heaven. An earlier generation of misguided development efforts left Africa dotted with silent "white elephant" factories, and the present generation of revolutionary reforms in the post-socialist world left the region dotted with dysfunctional "cargo cult" institutions–the foremost among them being "Stock Markets" promoted by the US Agency for International Development, the World Bank, and the IMF.[4]

This idolatry of "Wall Street" has long existed in America where it creates the fundamental form of institutionalized irresponsibility in American-style capitalism where the control in the large firms is separated or disconnected from ownership. No matter how inchoate the Occupy Wall Street movements have been, they have at least focused some attention on the very heart of American-style capitalism.

Re-constituting the Corporation

There have been a few–very few–social commentators who have pointed out the institutionalized irresponsibility of the absentee-owned joint stock corporation. In his 1961 book aptly entitled *The Responsible Company*, George Goyder quoted a striking passage from Lord Eustace Percy's *Riddell Lectures* in 1944:

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2 *See the chapter on "Cargo Cult Science" in Feynman (1985).*

3 *See Jenko (1991).*

4 *See Ellerman (2005b: chap. 8).*

> *Here is the most urgent challenge to political invention ever offered to the jurist and the statesman. The human association which in fact produces and distributes wealth, the association of workmen, managers, technicians and directors, is not an association recognised by the law. The association which the law does recognise–the association of shareholders, creditors and directors–is incapable of production and is not expected by the law to perform these functions.* (Percy, 1944: 38; quoted in Goyder, 1961: 57)

There will, of course, be many reforms suggested to alleviate the symptoms of this institutional irresponsibility, e.g., the almost humorous Corporate Social Responsibility (CSR) Movement.[5] But *the basic solution* is the re-constitutionalizing of the corporation so that the "human association which in fact produces and distributes wealth" is recognized in law as the legal corporation where the ownership/membership in the company would be assigned to the "workmen, managers, technicians and directors" who work in the company. The staff of a company are the ones who could actually monitor the management of their company to address the corporate governance problem directly. "The only cohesive, workable, and effective constituency within view is the corporation's work force." (Flynn, 1973: 106)

This would be the application of the democratic principle to the workplace; those who are governed or managed would have the vote to determine their governors or managers. The shareholders have already been turned into *de facto* bondholders so this re-constitutionalizing of the corporation would only legalize their status as creditors, not "owners," of the corporation. Yet with very few exceptions (e.g., Dahl, 1985), the established political scientists, economists, and social commentators have closely adhered to their social role of "accounting" for the system by avoiding that workplace democracy issue.

But the idea is rather old. John Stuart Mill brought the issue fully into focus in the middle of the 19th century. In his *Principles of Political Economy* (1848), Mill considered how the form of work would affect human capabilities and how the workplace association could become a school for the civic virtues if it progressed beyond the employment or master-servant relation (the institution of renting[6] or hiring people in economics).

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[5] *Try to find a single statement in the entire corporate social responsibility literature criticizing absentee ownership (facilitated and sponsored by the stock market) as the mother of all disconnects behind corporate irresponsibility.*

[6] *"Since slavery was abolished, human earning power is forbidden by law to be capitalized. A man is not even free to sell himself: he must* ***rent*** *himself at a wage." (Samuelson, 1976: 52 (emphasis in original)) Or "We do not have asset prices in the labor market because workers cannot be bought or sold in modern societies; they can only be rented. (In a society with slavery, the asset price would be the price of a slave.)" (Fischer et al., 1988: 323)*

But if public spirit, generous sentiments, or true justice and equality are desired, association, not isolation, of interests, is the school in which these excellences are nurtured. The aim of improvement should be not solely to place human beings in a condition in which they will be able to do without one another, but to enable them to work with or for one another in relations not involving dependence.

Previously those who lived by labor and were not individually self-employed would have to work "for a master."

But the civilizing and improving influences of association, ..., may be obtained without dividing the producers into two parties with hostile interests and feelings, the many who do the work being mere servants under the command of the one who supplies the funds, and having no interest of their own in the enterprise except to earn their wages with as little labor as possible.

One halfway house in this direction would be various forms of association between capital and labor.

The form of association, however, which if mankind continue to improve, must be expected in the end to predominate, is not that which can exist between a capitalist as chief, and workpeople without a voice in the management, but the association of the labourers themselves on terms of equality, collectively owning the capital with which they carry on their operations, and working under managers elected and removable by themselves.

Then "the human association which in fact produces and distributes wealth" would receive the fruits of their labor—the responsibility principle that is supposed to be the basis for private property (Ellerman, 1992)—so Mill sees an increase in the productivity of work; the workers would then have the enterprise as "their principle and their interest."

It is scarcely possible to rate too highly this material benefit, which yet is as nothing compared with the moral revolution in society that would accompany it: the healing of the standing feud between capital and labour; the transformation of human life, from a conflict of classes struggling for opposite interests, to a friendly rivalry in the pursuit of a good common to all; the elevation of the dignity of labour; a new sense of security and independence in the labouring class; and the conversion of each human being's daily occupation into a school of the social *sympathies and the practical intelligence.* (Mill, 1848/1970: Book IV, Chapter VII)

Social scientists have done such an excellent job of limiting the topics that could be seriously considered that the recommendations of even such an establishment figure as John Stuart Mill still sound radical and beyond the pale after more than a century and a half.

Concluding Remarks

Not all market economies have rushed headlong to imitate that "envy of the world," Wall Street capitalism. The Japanese idea of the company-as-community (Dore, 1987) is the basis for a fully competitive "employee-favouring" (as opposed to "shareholder-favouring") model (Dore, 2000).

Germany has also developed more responsible and even "employee-favouring" forms of enterprise. The German institution of *Mitbestimmung* (Dore, 2000) is inconceivable in the American-style corporation which treats the livelihood of the people in the firm as cost category to be minimized in whatever way possible. This includes moving the jobs to low-cost labor elsewhere–which has the added effect of slowly deindustrializing the country, devastating the economic base of whole regions, and slowly demolishing the middle class–all the while creating unimagined wealth for the few in control.

The most direct alternatives to the absentee-owned corporations are the employee-owned corporations and the worker cooperative corporations[7] that are being experimented with around the world.[8] In Europe, there is a sizable group of LEGA cooperatives in northern Italy[9] but the best-known example is the group of Mondragon cooperatives in the Basque region of Spain.[10]

Yet these attempts in other countries to create and maintain some semblance of institutional responsibility in a market economy must constantly weather a gale of criticism. During the Cold War, any alternative more responsible form of a market economy, e.g., the idea of a social market economy, smacked of crypto-socialism.

[7] *It should be noted that the problem in the absentee-owned corporation is not that it is a corporation in the sense of being a legal "person," i.e., a separate legal party from its members or shareholders. Worker cooperatives are also corporations but have no alienable equity shares of stock (see Ellerman and Pitegoff, 1983).*

[8] *See Erdal (2011) for an excellent recent treatment.*

[9] *See Jones and Zevi (1993) and Jones (2007).*

[10] *See Whyte and Whyte (1991) as well as many other accounts available on the Internet in addition to Mondragon's own website (2012). For an analysis of the innovative features of the Mondragon cooperatives and of the structure of democratic firms in general, see Ellerman (2007).*

Now the Cold War is over and socialism lost, so the practice continues of denigrating any alternative more responsible institutions as displaying “socialistic tendencies.” Indeed, since “America won the Cold War,” Wall Street capitalism is very widely seen as *the* model for an “advanced” market economy. The more responsible institutions in the German-style or Japanese-style market economies as well as the experiments with employee ownership and cooperatives are seen as backward, retrograde, or atavistic in the face of all the latest “innovations and advances” in Wall Street capitalism. The constant refrain is: “Why shouldn’t the political and economic leaders want the ‘very best institutions’ for their people?”

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