

# Islands and the sea: making firm-level democracy durable

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## Introduction

Firms are islands of planning in a sea of markets and arms-lengths transactions. In her anchor essay as in her book, Isabelle Ferreras argues that the problem with neoliberal capitalism is primarily with the islands and their internal structures of government, not with the relations between them: “the problem ... is less a problem of the *market* than a problem of the *corporation*.” (Ferreras 2017, 19 italics original).

In this paper, I will argue that the problem is at least a shared one, a durable solution to which requires tackling both corporations and the ecosystem they are embedded in, and in particular financial markets.

I will show the causal mechanism at the heart of this argument through telling a stylised history of another islands-within-a-sea constellation. In this one, a great storm led to the democratisation of key islands, achieving, to a significant albeit imperfect extent what Ferreras proposes for firms. Later, however, this internal democratisation was rolled back because of changes in the interactions between them.

The upshot of this is two-fold: first, it shows that the two aspects—internal organisation and external ecosystem—must be considered together. Second, it shows that even successfully democratised islands may be destabilised or corrupted by interactions across the sea.

If the same causal mechanism that I demonstrate in the example below also applies to firms, it follows that the democratisation of firms, in order to be durable, must be accompanied by democratising the sea around them. In practice, this means democratising the financial and product markets that constitute the ecosystem into which firms are embedded. Failing this, the

democratisation of firms may remain incomplete and more importantly, over the medium- to long-run, fleeting.

Since multiple proposals for democratising markets and finance have already been advanced (e.g. Malleson 2014; Block 2019; Hockett 2019), the last section of the paper turns toward considering how these would fit together with Ferreras' proposal for democratising the firm. The preliminary conclusion is that these proposals mesh well. Three open questions remain, however, on how to fully and *durably* democratise a division of labour: how to regulate firms' merger and acquisition (M&A) activity, what to do about international commerce, and how to assure sufficient dynamism once finance and firms are both democratised.

### **To democracy and back: control over the division of labour in Western Europe and North America in the 20<sup>th</sup> century**

The islands referred to above are the nation states of Western Europe and North America. The sea between them, the international financial and commercial system. The great storm was the first half of the 20<sup>th</sup> century, in particular the two World Wars. Their democratisation was the extension of voting rights, the creation of Bretton Woods, and the wider post-WWII settlement. And the roll-back of democracy, the transition from the post-WWII settlement to neoliberalism.

As is well known, during and after WWII the extent of public control over the division of labour expanded dramatically. "Democratic institutions challenged the basic operations of the capitalist economy" (Bowles and Gintis 1986, 5), full employment, strong trade unions, the nationalisation of certain commanding heights of industry, and tightly regulated financial sectors replaced the discretionary control that owners of capital and senior managers had previously held. This was accompanied by an extension of voting rights, with women's suffrage introduced in France in 1944, in Italy in 1945, and in Japan in 1946.<sup>1</sup> In the US,

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<sup>1</sup> The first major wave of women's suffrage had come in the wake of WWI, with Germany adopting it in 1918, the UK in 1918/1928, Sweden in 1919, and the United States 1920.

“[b]etween the late 1950s and the early 1970s [...] nearly all formal restrictions on the suffrage rights of adult citizens were swept away, and the federal government assumed responsibility for protecting and guaranteeing those rights” (Keyssar 2009, 205).

Equally well known is that, during the 1970s and 1980s, this Keynesian-Social Democratic settlement gave way to what may be called Neoliberal Globalism (Slobodian 2018), or simply the neoliberal settlement. The defining feature of this new settlement was that markets, and the corporations within them, were clad in depoliticizing armour, “to [re]inoculate capitalism against the threat of democracy” (Slobodian 2018, 2). The most important components of this cladding are independent central banks, deregulated but publicly backstopped financial systems, commercial federalism,<sup>2</sup> and an intellectual and in places constitutional architecture of single equilibrium.<sup>3</sup>

In this settlement, the contours of the division of labour—and thus, to a significant extent, social macro-structures and the texture and fabric of daily life—are determined by the

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<sup>2</sup> By commercial federalism I mean the deliberate construction of market orders that exceed the scope of existing democratic states. Insofar as markets always require political undergirding, this is necessarily a form of political federalism, but since the avowed goal is market creation (through the “integration” of multiple smaller markets) rather than, say, common defence, I term it commercial federalism. Prominent contemporary examples of this include the European Union, NAFTA (now USMCA), AFTA, SAFTA, MERCOSUR, the Eurasian Economic Union, and ECOWAS (as well as the other Regional Economic Communities of the African Economic Community). For an acute & prescient analysis of the political consequences of commercial federalism, see Hayek (1948).

<sup>3</sup> The heart of what I call an architecture of single equilibrium is the claim that there is no viable alternative to a capital-friendly market system. Since in fact there is an abundance of multiple equilibria, some of which are far less capital friendly (even internal only to the family of largely market-coordinated divisions of labour), this single equilibrium claim must be supported by both intellectual and constitutional architectures in order to appear credible. Key pillars of the associated intellectual architecture are claims like: only a fully commodified labour market can produce the highest sustainable levels of employment and wages (Hayek 1960, 270); Keynesian fiscal policy is futile at best, strongly counter-productive at worst (Hayek 2007 [1944], p. 214); monetary policy cannot have real effects, other than leading to escalating inflation and a loss of prosperity (Lucas 1976; Lucas and Sargent 1981); and using taxes and public spending to achieve collectively determined ends greatly harms growth (Stigler 1979, 61). Examples of the associated constitutional architecture include balanced budget amendments, as introduced in Germany and a number of other Eurozone countries in the 2000s, the EU’s State Aid rules, or, in the US, the extensive use of First Amendment jurisprudence to limit legislation on advertisement, health and safety practices, and privacy (Sitaraman 2017, 266–68).

decisions of private investors, asset managers, bankers, and senior managers. They are no longer primarily determined by majority rule or popular sovereignty. While contested elections proceed on a regular basis, the press remains free (so long as it is profitable), and other important freedoms (e.g. of association, assembly, or religion) continue to be protected, the cladding that encases markets against majorities empties democracy of much of its substance (Brown 2015).

Numerous consequences ensued: life risks related to employment, housing, retirement income, and healthcare have been shifted from firms and states onto workers and families (Hacker [2006] 2019). Due to changes in tax policies, labour market structures, trade patterns, and trade union strength, income and wealth inequality have increased, dramatically so in anglophone countries and parts of the Global South, noticeably so on the European continent and elsewhere (Piketty 2014). Pockets of poverty have grown among increasing riches; insecurity among plenty has become endemic (Shapiro and Graetz 2020, Azmanova 2020). Climate change and other threats to planetary sustainability are tackled slowly, if at all. And perhaps most strikingly—not least because it echoes the end of the Soviet Union so clearly—life expectancy has begun to decline for large segments of the American, and most recently English, populations (Case and Deaton 2020; Marmot et al. 2020).

Both institutionally and in terms of outcomes, these developments render credible the claim that democratic control over the division of labour has been hollowed out, and with it, much of democracy itself (for concurrent judgements, see Crouch 2011; Gilens and Page 2014; Brown 2015; Elsässer, Hense, and Schäfer 2018; for an opposing take, see Iversen and Soskice 2019).

In the next sections I offer a highly stylised history, process-tracing the transition from Bretton Woods to Neoliberal Globalism in the financial sector, a key locus of control over the division of labour. In this stylised account I highlight the importance of the sea—international

financial relations—in the process. In the sections that follow, I extract the generic causal mechanism at work in this story, explain how it applies to firms-within-markets, and then explore whether a combination of Ferreras’ proposal with those of Malleson and Block and Hockett offers a coherent and viable response to this mechanism.

### **Eurodollars and initial inroads against Bretton Woods**

In the wake of World War II, with the decline of Sterling as a global reserve currency, the City of London had gone into decline. Business was sleepy, squeezed between dollar ascendancy and the restrictions that the Bretton Woods framework imposed on international financial transactions. When the Midland Bank, one of Britain’s four biggest banks at the time, discovered a profitable albeit dubious arbitrage opportunity, the Bank of England—keen to revive the City’s fortunes—was inclined to turn a blind eye.

What the Midland Bank had discovered, in the spring of 1955, was that it could make a risk-free (arbitrage) profit by attracting American dollar deposits at low rates, converting them into sterling while hedging the exchange rate risk, then lending them to various UK borrowers at a profit. The transaction structure as a whole skirted Bretton Woods limits on international capital mobility, but each individual step was technically permitted, or at least not prohibited: “Midland was violating the spirit of exchange control but was not strictly beyond the law in its actions” (Schenk 1998, 227).

The arbitrage operation worked as follows: the bank offered interested customers an interest rate of 1.875% on 30-day US dollar time deposits. This was 0.875% more than American banks could legally offer at the time: under Regulation Q, US banks were subject to a cap of 1% (Ruebling 1970, 32). Because the dollars were deposited with a *European* bank, Regulation Q did not obviously apply. This exception gave rise to the term “Eurodollars”: dollars that are deposited at banks not under American jurisdiction, hence exempt from the strict system of financial regulation that emerged from the New Deal.

Given the higher rate it offered, the Midland Bank quickly attracted a large volume of dollar deposits.<sup>4</sup> In the next step, it sold the newly acquired dollars to buy pounds sterling. To remove exchange rate and liquidity risk, the bank simultaneously concluded agreements to buy back these dollars 30 days later, to be assured it would have the dollars it would need to pay out its dollar depositors, should they choose to withdraw their money (which they could do at 30 days' notice). To secure this future re-purchase, the Midland Bank had to pay a 2.125% premium.

The result was that the Midland Bank got hold of sterling funds at a cost of 4%, 1.875% of which went to its dollar depositors, 2.125% to its exchange rate hedge counterparty. This was cheaper than “locally sourced” pounds sterling from the Bank of England: The Bank Rate, i.e. the cost of short term borrowing from the Bank of England, was 4.5% at the time. And it provided a larger volume than what the Midland Bank could attract from its British depositors (Schenk 1998, 225–27).<sup>5</sup> It is not fully clear to whom the Midland Bank lent the thus-procured funds, but because UK financial conditions had suddenly become very tight at the beginning of 1955—the Bank Rate had been raised from 3% to 4.5% in less than two months—there was no shortage of profitable investment opportunities in the U.K. to which these funds could be lent (Schenk 1998, 226).

For the purposes of the argument developed here, the crucial effect to notice is that the Midland Bank's arbitrage operation undermined Regulation Q. US banks, who were banned from offering interest rates above 1% on time deposits, suddenly had to compete with a British

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<sup>4</sup> By July 1955, the Midland Bank had attracted around £70 million in dollar deposits, the equivalent of around £1.8 billion today (Schenk 1998, 226).

<sup>5</sup> An informal agreement—to always pay an interest of 2% below Bank Rate, i.e. 2.5% in this case—between the major British banks prevented the Midland Bank from attracting additional sterling deposits by offering higher deposit rates to its British customers. In addition, the interest rate on British government bonds, which usually hovered around 0.5% above the deposit rate (i.e. which should have been at around 3% at the time), had risen to around 4%, so that households and firms were withdrawing money from their UK bank accounts and putting it into UK government bonds instead.

bank offering customers 1.875% for their dollar deposits. Needless to say, US banks were less than thrilled.

### **Regulation Q, the lynchpin of New Deal financial reform**

To understand the stakes of this pressure on Regulation Q, its pivotal role in the post-New Deal financial system must be explained. As mentioned above, Regulation Q capped the interest rate that American banks could pay to their depositors.<sup>6</sup> What was this regulation designed to achieve? Why was it important?

New Deal financial reform had three main purposes: to reduce overall risk-taking in the financial sector, which was seen as a cause of the 1929 crash; to boost the volume of lending so to stimulate business activity and exit the Great Depression; and to prioritise particular kinds of lending (e.g. lending to white households for mortgages, or lending to commercial and industrial businesses for investment) over other kinds of lending (e.g. lending to businesses for M&A, or lending to households or financial firms for stock market or currency speculation). The preamble of its legislative centre-piece, the 1933 Banking Act, read: “AN ACT To provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations, and for other purposes.”<sup>7</sup>

Both the first and the third goal were closely linked to Regulation Q. Since banks are generally profit maximising institutions, the reason why they engaged in high-risk lending or in lending for speculation was that they expected more profits from doing so.<sup>8</sup> High risk, high

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<sup>6</sup> To be precise, Regulation Q banned banks from paying any interest on demand deposits (ordinary checking accounts), and capped the rate that could be paid on savings and time deposits, at the Federal Reserve’s discretion. When Regulation Q was introduced in 1933, the cap was fixed at 3% for all time and savings deposits, but in 1936 distinctions were introduced between savings deposits (2.5%), time deposits of less than 90 days (1%), time deposits of 90 days to six months (2%) and time deposits longer than six months (2.5%) (Ruebling 1970; Gilbert 1986).

<sup>7</sup> For an accessible and brief history of the tightening and then loosening of US financial regulation over the course of the 20<sup>th</sup> century, see Sherman (2009).

<sup>8</sup> For the canonical argument that banks, left to their own devices, generally gravitate towards this kind of lending

interest rate loans, often to finance speculation on Wall Street, had been a way for banks to participate in the stock market rally of the 1920s, offering better returns than the kind of mortgage lending or lending for industrial investments that Congress and FDR saw as more desirable. To reign this in, the 1933 Banking Act introduced a number of measures that directly targeted these forms of lending.<sup>9</sup>

However, enterprising lawyers could (and can) build contractual arrangements that abide by the letter of the law, while circumventing its spirit (Silber 1983; Pistor 2019). So, in addition to the direct measures taken to reduce the volume of high risk and other undesirable lending, Regulation Q was introduced as a flanking measure, to ensure that the competitive pressure to engage in these forms of lending would be muted.

This worked in the following fashion: imagine some adventurous lender, say an American cousin of the Midland Bank, begins to skirt the law in order to engage in precisely the kind of high-profit, high-risk lending that New Deal regulation was supposed to clamp down on. Because this lending is more profitable than run-of-the-mill operations—whence the need to limit it through regulation—such a bank would be capable of paying higher interest rates to its depositors. If the bank now started to offer such rates—like the Midland Bank did when it offered 1.875% against the 1% offered by everyone else—it would quickly attract more depositors, allowing its legality-skirting business to grow.

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or investing, see Minsky (1986).

<sup>9</sup> This included, for example, limiting the amount of lending a bank could offer that was secured against bonds or stocks. This was a classic way for speculators to raise additional funds: stocks or bonds they had purchased would be taken to the bank and offered as collateral to borrow more money, with which to buy further stocks or bonds, to then place again as collateral for further borrowing, and so on. Another measure introduced to this end was to task each of the 12 Federal Reserve Banks with the mission to “keep itself informed of the general character and amount of the loans and investments of its member banks”, to ascertain whether “undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions.” Remarkably, where a Federal Reserve Bank found a bank to be engaged in such unkosher lending, “in determining whether to grant or refuse advances, rediscounts or other credit accommodations, the Federal reserve bank shall give consideration to such information”, and “the [Federal Reserve] Board may, *in its discretion* ... suspend such bank from the use of the credit facilities of the Federal Reserve System” (Banking Act of 1933, Section 3 (a), italics added).



Other banks who abide by the spirit of the law would now face a double pressure. Their depositors would withdraw funds to reap the higher returns offered by the more buccaneering bank; and their shareholders would complain about the lower dividends they receive, relative to those offered by the buccaneers.<sup>10</sup> By capping the interest that banks can pay on deposits, Regulation Q put a stop to this mechanism.

In addition, Regulation Q also included a provision that allowed institutions specializing in mortgage finance, savings and loans associations (also known as thrifts), to offer 0.25% more on deposits. “This was explicitly designed to encourage a flow of money into housing” (Sherman 2009, 4), in part because housing was seen as a central, labour-intensive industry whose reboot could reduce unemployment and jumpstart the economy as a whole.

Regulation Q therefore reduced the pressure for banks to engage in high risk lending, and at the same time channelled funding towards mortgages and the construction sector. It guided credit, and so economic activity, towards an alternative path from the one that profit-maximising banks would have chosen by themselves. As such, it was an archetypical example of credit guidance, one of the key factors driving up US homeownership rates from around 45% in the 1920s and 1930s to more than 60% by the 1970s (U.S. Census Bureau 1976, 646), and thus one of the causes behind the rise of the patrimonial middle class in the United States (Piketty 2014, 261–62).

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<sup>10</sup> Indeed, some argue that the strict system of banking regulation in the US (prior to late-20<sup>th</sup> century deregulation) was responsible for the rise of the shadow banking system and the greater importance of the stock market there (Roe 1996). Similar arguments have been made concerning the rise of shadow banking after the tightening of regulation that followed 2008. This meshes well with the account given here: credit guidance means that the flow of credit is redirected from where it would otherwise go. This means that at least some profitable (even if socially undesirable) lending opportunities do not receive credit (which is instead channelled, for example, towards less profitable business ventures with known positive externalities or desirable social effects, or poorer households or households with higher risks of non-repayment), which in turn creates incentives to build alternative channels to connect returns-hungry investors with confident-of-future-profit entrepreneurs: alternative channels like shadow banking or the stock market.

Of course, in practice some banks still skirted the regulations and credit guidance emerging from New Deal financial reform, often reaping temporarily higher profits from doing so. But Regulation Q prevented them from using their profits to scale up via rapidly attracting large amounts of deposits through openly offering higher deposit interest rates. In addition, the ban on banks operating in multiple states prevented such buccaneers from scaling up via buying rival banks.<sup>11</sup> In this way, upstanding banks were protected against commercial pressure to also start skirting the law. By slowing the spread of “skirting practices”, the probability was increased that buccaneering banks (or at least their questionable new lending practices) would get shut down at source before too many others copied them, at which point an attempt to shut the practice down would have faced far more serious resistance from the banking sector as a whole.

To render this mechanism more concrete, as well as to see its ambivalent nature, consider the following example from housing finance. In 1962, “the Chicago Commission on Human Relations studied one block of Chicago intensively and noted that black families were charged much more for houses than white families had sold them for.” What enabled this racist pricing structure? “White speculators were making a tidy business of the fact that black families could not get low interest rates” (Prasad 2012, 222).

Note three features of this situation: financial regulation created a gap between the financing costs of two otherwise very similar projects: white home ownership and black homeownership. This was as intended: financial regulation serves precisely to prioritise some forms of lending (and hence some kinds of projects) over others. In the general description offered above, mortgage lending and lending for industrial investment were prioritised over

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<sup>11</sup> This restriction was only fully lifted with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

high-risk, high-profit lending to finance stock and bond market speculation. In this case, lending to white families was prioritised over lending to black families, reflecting the racism of the mid-century American state.

Second, it was precisely the thus-created gap that opened an opportunity for the kind of buccaneer mentioned above: in this case, a white speculator who buys cheap from a white seller, and sells dear to a black buyer.

Third, the *extent* to which such a speculator could hollow out existing financial regulation and credit guidance depended on the amount of capital they could get access to. A speculator with little capital could only “flip” one house at a time, while a speculator with lots of capital could flip many houses at once.

This is where the example of housing finance in Chicago in 1962 reconnects with the bigger picture, Regulation Q: had this kind of speculator been able to offer high interest rates for deposits (paid from the excessive profit reaped by buying cheap from white families and selling dear to black ones), they could have attracted lots of capital and used it to systematically erode the regulatory framework. Though that would have been desirable in this case, for it would have closed the spread in interest rates and credit availability created by racist financial regulation (in particular redlining),<sup>12</sup> this shows how Regulation Q was essential to stabilize the system of credit guidance and risk reduction that emerged from New Deal financial reform.

The post-New Deal financial system “was a highly compartmentalized system in which distinct institutions serving discrete functions were protected from direct competition with one another” (Krippner 2011, 61). Regulation Q was its lynchpin: the channel embankment that guided funds towards mortgages and industry, by preventing rogue buccaneers—a few of which would always and inevitably emerge in a large, commercially-spirited society like the US—from attracting funds for undesirable lending (e.g. stock market speculation). This

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<sup>12</sup> On redlining, see for example Jackson (1985), Cohen (2003), or Freund (2007).

preserved the compartmentalization of the American financial system which in turn allowed public policy to direct the flows of finance in line with—sometimes reprehensible—government priorities.

### **Eurodollars and the erosion of Regulation Q, continued**

With the importance of Regulation Q established, let us return to the main story. The Midland Bank's creation of Eurodollar deposits put pressure on Regulation Q. To ward off this pressure, the US government could have extended Regulation Q to apply to foreign banks as well.<sup>13</sup> This would have levelled the playing field, reduced competitive pressure on American banks, and alleviated the amount of lobbying that banks were directing at the government.

However, the US never extended Regulation Q to cover banks operating outside of the US. Why? First, "American banks quickly came to dominate" the Eurodollar market, through their London-based subsidiaries (who, in virtue of their location, were exempt from US regulation) (Schenk 1998, 232). Through opening up new profit opportunities for American banks, this reduced the pressure for financial reform in the US itself. This "safety vent" function became particularly important when the US imposed capital controls in the early 1960s: "By moving their international dollar business to London, [US banks] were able to avoid the restrictions placed on their international activities by the [1960s] capital controls program and to retain their dominant place in international finance. Indeed, once the bankers had recognized the availability of this option, their opposition to the program diminished considerably." (Helleiner 1994, 88).

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<sup>13</sup> The power of the US government to regulate foreign financial institutions is grounded in the desirability of access to the American market. While it cannot literally coerce foreign banks to abide by US regulation, it can force them to choose between operating on the US market, at the price of accepting American terms in all their operations (US-based and elsewhere), or be excluded from this market. As the recent Iran sanctions show, the vast majority of financial institutions respond to this choice by obeying US regulations.

Second, the US decided to stay its hand regarding Regulation Q's coverage because looking the other way on offshore dollars made US dollars more attractive assets for foreign firms and governments. Had Regulation Q been extended to offshore dollars, British multinational firms, for example, when choosing between holding their working capital in a 1%-yielding dollar deposit (whose rate would then have been capped regardless of whether it was held in a US- or UK-based bank) or a 3%-yielding pound deposit would, all else being equal, have chosen the pound deposit. By allowing offshore dollar deposits to pay higher rates, foreign firms and governments were rendered more likely to keep their trade earnings and official reserves in US dollars, rather than repatriate them into other currencies.

This was a secondary concern while the US was running current account surpluses. As long as the US was exporting more than it was importing, the US government did not need to worry about the capital management practices of foreign firms and governments: in virtue of the current account surpluses, foreign-held dollars, which under Bretton Woods represented a claim on US gold reserves, would return to the US over time.

However, once a combination of growing European and Japanese exports, the Vietnam War, and the Great Society programmes pushed the US into a structural current account deficit, it became vital to entice foreign firms and governments to hold dollars rather than convert them into other currencies. As with the UK in 1976, France under Mitterrand in 1981-3, or many a developing country government over the years, its current account deficit put the US government before an ugly option set: i) running out of foreign currency and gold reserves, if foreign dollar holders chose to convert their dollars into pounds, deutschmark, yen, or gold, rendering it impossible to maintain the dollar at its fixed exchange rate. ii) Devaluing its currency again and again, either through devaluations inside the Bretton Woods system of fixed exchange rates, or through switching to a floating currency, until the current account balances.

This would have led to resistance from trade partners, to an outflow of investments,<sup>14</sup> and to a weakening of the US dollar's role in global finance. Or iii) implementing domestic austerity, to reduce imports and thus balance the current account without continuous devaluations, but with predictable political consequences for the government doing it.

Unlike Callaghan's Britain or Mitterrand's France, however, in virtue of issuing the world's dominant reserve currency, the US had a fourth option, the "exorbitant privilege" (Eichengreen 2010): inducing foreigners not to exchange the money that they earned through their collective current account surplus vis-à-vis the US, keeping their export earnings in US dollars instead. "That the [Eurodollar] market encouraged dollar holdings was widely understood by American policymakers ... Faced with growing external deficits, the government sought to avoid undertaking adjustment measures [i.e. austerity or devaluations] by encouraging foreign governments and private investors to finance these deficits. Central to this strategy was the attractiveness of the Eurodollar market to foreigners. Taking an approach that would prevail through the 1970s and 1980s, Washington policymakers fostered a more liberal international financial system as a way of preserving their policy autonomy in the face of growing external constraints." (Helleiner 1994, 90–91).

With neither the UK nor the US clamping down on Eurodollars, the Euromarkets<sup>15</sup> rapidly grew in size, "from roughly \$1.5 billion in the late 1950s to \$71 billion in 1971, \$91 billion in 1972, and \$132 billion in 1973" (Ogle 2017, 1446). Although these numbers are

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<sup>14</sup> A continually devaluing exchange rate means, for a foreign investor, that the (home currency) value of US assets is continually falling, making investments in the US inherently unattractive, while for US investors the (dollar) value of foreign assets is continually appreciating, making investments abroad inherently attractive.

<sup>15</sup> Euromarkets included both Eurodollar deposits and market-based lending (called "Eurobonds"), through which firms, municipalities, and other borrowers could borrow these dollar funds. For simplicity, I skip over the development of the lending side of these markets, which lagged behind the deposit side by a few years, but followed its general trajectory.

imprecise—Euromarkets were as much about secrecy and tax evasion, which in their nature lead to murky numbers, as they were about above-board arbitrage (Ogle 2017)—they indicate the orders of magnitude reached by the 1970s: around 10% of US GDP, or up to 50% of the GDP of the major European economies, i.e. West Germany, France, the UK, and Italy.

This growth in size was crucial. It meant two things: first, for governments in their role as *shepherds of economic growth*, these markets now represented a large and growing industry that would provide local jobs and tax revenues to the states that could attract it to its shores. When New York City came close to bankruptcy in the mid-1970s, it was unsurprising that it chose to roll out the red carpet to attract this footloose industry. Through legislating a new kind of corporate entity in 1978, “International Banking Facilities” (IBFs), New York “would attract banks ... by offering what was par for the course in tax havens.” Besides lower reserve ratios, “[t]he longstanding ceiling on the amount of interest that banks were allowed to pay on deposits [i.e. Regulation Q] was lifted for IBFs. Federal income tax would be applied to any revenue they generated, but state and local taxes were suspended” (Ogle 2017, 1453).

While IBFs were not allowed to accept deposits from, or issue loans to, American-registered companies or individuals, they were free to accept deposits from and issue loans to foreign governments, individuals, and firms, crucially including the foreign subsidiaries of US firms (Ogle 2017, 1453 footnote 82). Given sufficient legal engineering, this meant that IBFs were accessible to US Multi-National Corporations (MNCs), on condition of routing credit flows through their foreign subsidiaries. This gave US MNCs an advantage over smaller, purely US-based firms: the latter could not access the higher interest rate deposits offered by IBFs, nor the less regulated financing offered by them. Looking for a level playing field, small- and mid-sized US firms and banks now had a strong reason to lobby for dismantling the New Deal financial system, as well as request reductions on the state and local taxes from which internationally operating banks were exempt.

Second, for governments in their role as *borrowers*, it provided a financial infrastructure to attract large amounts of non-inflationary finance, as long as they offered attractive terms to international financiers. As growth fell and inflation became a persistent problem in the 1970s, this became an offer they could not refuse. When oil prices shot up (Yergin 2009; Jacobs 2016; Dietrich 2017) and the rate of productivity increase declined in the early 1970s (Gordon 2016), politicians were faced with a choice between reducing worker and consumer living standards (whether via higher taxes, including inflation as a furtive tax, or lower spending), reducing profits (though, since profit rates were already low by historical standards, this would have required a growing share of investment to be directed and coordinated by the public sector), or attracting some of this footloose capital. Many, particularly at the local and regional level, chose the latter option: as early as 1976, even before the major waves of financial de-regulation in the US (taking place in 1980, 1994 and 1999) and the UK (1986), more than 40% of all lending on Euromarkets went to public sector entities, including “Scandinavian, Dutch, British, and Japanese municipalities seeking to expand their stock of public housing and the like; public corporations in Spain and Italy that were building highways and roads; and newly nationalized industries in France or Britain, such as *Électricité de France*” (Ogle 2017, 1449).

The re-emergence of international finance—born out of a British desire to revive the City of London, tolerated by the US because it alleviated pressure on US gold reserves and took the edge off of US banks’ lobbying efforts against the New Deal financial system at home—thus offered states, incl. local authorities and state-owned enterprises, the opportunity for non-inflationary borrowing. Large sums could be borrowed from the Euromarkets, a flourishing industry could be attracted to your shores, as long as states abided by investor demands, which, unsurprisingly, included a relaxation of capital controls and other financial regulation.



### **France folds: financial deregulation and the end of social democracy in one country**

The potency of this temptation to trigger fundamental departures from the post-WWII settlement was revealed most strikingly not in Reagan's US or Thatcher's UK, but in François Mitterrand's France. As with the toleration of Euromarkets by the UK and the US, the French path to financial deregulation, too, was driven by the advantages it offered to state actors (Abdelal 2007). In particular, much like the Euromarkets, deregulating the French financial sector would allow the French state as well as French industry and households to borrow cheaply and without causing additional inflation. What rendered this instance of the same causal pattern so striking was that it was implemented by a socialist government that had been elected on a strongly anti-capitalist platform.<sup>16</sup>

During the post-war era, the *trente glorieuses*, French governments had regularly borrowed newly created funds from the *Banque de France*.<sup>17</sup> Credit to industry was dominated by state and quasi-public financial institutions.<sup>18</sup> However, these practices were inflationary unless offset by sufficient growth, increased taxation, higher interest rates for non-privileged borrowers, or other regulatory changes that reduced bank lending elsewhere and so freed up space to be filled by government spending and lending to prioritised sectors.

As productivity growth fell below expectations in the 1970s and early 1980s, it became necessary to take demand out of the system in order to reduce inflation. This meant either

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<sup>16</sup> The *Parti Socialiste*'s policy programme for 1981, entitled *The Socialist Project for France in the 1980s*, for example stated "We wish to establish a method, as precise and concrete as possible, to move from one economic, social, cultural, and therefore political social order to a different one, from the capitalist system in France to socialist society" (Parti Socialiste 1980, 10).

<sup>17</sup> The process operated with commercial and public banks as intermediaries, in a system known as the "circuit du Trésor." Since both public and private banks were legally required to deposit a certain part of their resources with the treasury, but could in turn re-finance their loans at the *Banque de France*, this intermediate step was technical.

<sup>18</sup> "Three-quarters of all loans to business in 1979 came from state or semipublic financial institutions, including nationalized banks and subsidiaries. Some 43 percent of all loans were subsidized by the state" (Loriaux 1991, 226).

reducing public and private borrowing, reducing wages (whether through taxes or pressure on trade unions for sub-inflation wage increases), increasing savings, or reducing profits.

Mitterrand was elected on the triple promise to break this impasse by reducing profits and generally distribute income and wealth downwards; nationalising large parts of French industry and the French banking system, making sure investment would continue apace despite lower profits; and ensuring full employment through classic Keynesian demand management, securing the full use of all productive capacities.

However, once Mitterrand's government started implementing this programme, it became clear that downward redistribution, large-scale nationalisations, and full employment policies were not compatible with France's integration into global product and financial markets. From the day of his election, France was bleeding currency.<sup>19</sup> Full employment policies, downwards redistribution, and lower profit rates all contributed to a structural balance of payments deficit: investors earned lower rates of return on domestic investments, creating an incentive to prioritise investment abroad. French workers enjoyed high incomes, thus drawing in imports from abroad and purchasing French goods that could otherwise have been exported. Also due to higher wages, French businesses faced higher costs, making their exports less competitive abroad.

Of the traditional two solutions to reduce imports (and hence redress the balance of payments deficit), neither was attractive: tariffs would clash with European market integration; domestic austerity with the government's avowed policy priorities, in particular full employment. Initially, the government thus deployed a variety of non-conventional tools to

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<sup>19</sup> Between 11<sup>th</sup> and 21<sup>st</sup> May the *Banque de France* spent a third of its foreign currency reserves buying francs to keep the exchange rate from falling below its minimum level in the European Monetary System (Fulla 2016, 393). This was despite three interest rate increases by the *Banque de France*, a 3.5% increase on 11<sup>th</sup> May 1981, a 2% hike on 15<sup>th</sup> May, and another 4% increase on 22<sup>nd</sup> of May, bringing the rate to an eye-watering 22% (INSEE 1982, 7).

bring the deficit under control, including borrowing on international financial markets,<sup>20</sup> boosting nuclear energy production and energy efficiency to reduce oil imports, and deliberately using administrative procedures to create obstacles to imports.<sup>21</sup> However, since these tools did not suffice to close the balance of payments deficit, Mitterrand was forced to choose between taking France out of the international division of labour, or re-structuring French society domestically to bring the balance of payments into a stable equilibrium.

Between June 1982 and March 1983, Mitterrand chose the latter option, in large part because this required less austerity in the short term,<sup>22</sup> but also because de-coupling from European economic integration would have imperilled the larger project of European political integration. To ease the pain of domestic restructuring, similar to decision-makers in the US (Krippner 2011) or Sweden (Blyth 2005), Mitterrand opted to accompany austerity with the deregulation of finance.<sup>23</sup>

In an echo of the New Deal financial order, French financial markets had been compartmentalised in the wake of WWII. Competition between banks was limited through an instrument called the *encadrement du crédit*, fulfilling a similar function to Regulation Q in the US, but in a more direct manner,<sup>24</sup> and capital controls had been introduced in the 1970s

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<sup>20</sup> In 1982, France borrowed in the region of \$20 billion on international markets, compared to \$26.5 billion by the US, and around \$12 billion and \$9 billion for Japan and Canada respectively (Loriaux 1991, 234).

<sup>21</sup> Examples of this included the requirement to submit all customs documentation in French, or that all VCR recorders—a product that was almost exclusively imported from Japan—had to be cleared at a single customs office in Poitiers, a small town in Western France without port or major airport (Asselain 2001, 414).

<sup>22</sup> Elisabeth Guigou and François-Xavier Stasse, two of the president’s closest economic advisors, estimated that closing the balance of payments deficit through domestic restructuring would require a reduction in domestic demand of 30 billion francs, while exiting from European monetary integration (which at this point was the EMS, or European Monetary System) would require a reduction of 50 billion. Note from F.-X. Stasse and E. Guigou to President Mitterrand from 8 March 1983 (French National Archives, Series AG/5(4)/4324, FXS.EG.PC 494), entitled “Objet : mise en oeuvre économique d’une sortie du S.M.E.”

<sup>23</sup> A comprehensive account of the history of financial deregulation in France is given by Lemoine (2016, in French, with an emphasis on public finances) or Loriaux (1991, in English, with an emphasis on international linkages, in particular to US policy).

<sup>24</sup> Unlike Regulation Q, which subdued competition through fixing maximum interest rates on deposits, the *encadrement du crédit* limited competition through placing direct limits on the amount of credit that individual

and early 1980s, to allow French interest rates to be pushed below global, and in particular US, interest rates, which had risen abruptly in 1980.<sup>25</sup> Deregulation therefore took the form of creating a money market (1984, with access extended beyond banks in 1985), which greatly reduced market compartmentalisation; abolishing capital controls (1984-6), which integrated French with international financial markets; and phasing out the *encadrement du credit* (1985-7), which exposed banks to harsher competition among each other (Loriaux 1991, 224-26).

The most important effect of financial deregulation was to allow for the real interest rate to increase, drawing purchasing power away from spending and into savings and so reducing inflation, without dampening credit growth, the usual consequence of an increase in interest rates. In particular, the real short-term interest rate increased from an average of around 0% during the 1970s to 4-5% in 1984-1987, its highest level since 1953.<sup>26</sup> Despite this increase, real credit growth increased from 0% in 1981 and around 3% in 1982-1984 to around 5% in 1985-1990, with spikes of 9% and 8% respectively in 1988 and 1989. Real growth in loans to households increased from 2-3% per year prior to deregulation to more than 10% p.a. in 1986, 1987, and 1988.<sup>27</sup> In significant part driven by financial deregulation, the CAC40, France's equivalent of the Dow Jones, experienced an unprecedented boom, rising from an average of around 360 points in 1982 to a peak of more than 1620 points on 26<sup>th</sup> March 1987, an increase of 350% in less than five years. At the same time, inflation fell from an annual rate of thirteen per cent in 1981 to a rate of three per cent in 1986 (OECD 2017, CPI Inflation).

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banks could lend to households and firms. Introduced temporarily in 1957, 1963, and 1968, it became a permanent feature of French financial regulation after 1972 (Loriaux 1991, 39).

<sup>25</sup> This sudden increase, to a peak of 20%, is generally known as the Volcker Shock, after the Chair of the Federal Reserve who implemented it.

<sup>26</sup> In addition, while 1953 saw short term interest rates averaging 6%, this was a one-off spike in the context of high volatility: the average real short-term rate in the year before was -8% (1952), in the year after (1954) around 4%, falling to 2% in 1955. In the late 1980s, in contrast, the real interest rate exceeded 4% every year for a decade (between 1984 and 1995, to be precise), rising above 5% in 1986 and between 1989 to 1995.

<sup>27</sup> All figures author's calculations, based on Jordà, Schularick and Taylor (2017).

In contrast, prior to deregulation, attacks on inflation meant that the *encadrement du crédit* “had to be tightened rather than loosened, exceptional tax levies had to be multiplied” and “interest rate policy [had to be] more deflationary than before” (Loriaux 1991, 235). Prior to deregulation, attacking inflation meant curtailing credit, which in turn meant lower investment, lower consumption, and lower growth.

Deregulation temporarily dissolved this binary choice and allowed inflation to come down without restricting credit growth. This allowed households to maintain consumption and to invest in assets despite lower-than-expected wage growth, and hence served to soften the backlash against Mitterrand’s turn towards austerity.

Yet deregulation was not costless. The consequences for the distribution of economic decision-making power were clear. Prior to reforms, the vast majority of credit had been allocated by state or semi-public financial institutions (see footnote 18 above). Through the tool of credit allocation, choices about which sectors to prioritise, what kinds of firms to support, or which regions to foster had been in public hands. After the reforms, it was “large banks” who “assumed an active role in industrial investment decisions by virtue of their strategic position between the [newly created] financial market on the one hand and indebted industrial borrowers on the other” (Loriaux 1991, 227).

By taking the bulk of capital allocation- and investment decisions out of public hands, not only was control ceded over the future structure of the division of labour, but—through making private lending and investment decisions the pivot of macroeconomic adjustment—investors and financial firms were turned into the judges of (macro)economic policy.

Although the abandonment of the Keynesian-Social Democratic settlement was multi-faceted and multi-phase, the surrender of finance to private discretion amounted to removing its keystone feature. Once capital allocation decisions, both internal to individual economies and between them, were given over to private banks and investors, systematically deviating

from the wishes of capital became costly. While decisions on labour market policy, healthcare, education, taxes, transport infrastructure, and other areas continued to have their own contingencies and eventfulness, a prevailing wind had been unleashed, favouring market-conforming reforms, eroding profit-reducing measures, and impeding democratic control over the division of labour.

**The causal mechanism: “bribing capital”**

The stylised history offered in the previous sections charted three selected episodes in the post-WWII development of finance in the capitalist core: British buccaneering, initiated in the 1950s by the Midland Bank; American inaction then emulation, as the erosion of Regulation Q was first tolerated then absorbed into domestic law; and French resistance then surrender, as Mitterrand used financial deregulation to soften the sting of austerity. From tightly regulated financial systems, embedded in separate national containers and allowing governments to retain control over credit flows, finance evolved into a loosely regulated global system, in which credit was allocated by profit-maximising banks and investors. This system continued to rely on public support—independent central banks provided assurance that inevitable financial crises would be followed by equally inevitable rescue operations—but ideologically captive central bankers again and again reassured investors that their interventions would remain “market neutral”, no matter the discretion available to them (van ’t Klooster and Fontan 2019). As Abdelal eloquently put it, this is the story of how “capital ruled” became “capital rules” (Abdelal 2007).

What causal mechanism can we extract from this stylised history? And how does it apply to firms embedded in financial and product markets, as opposed to states embedded in an international financial and economic order?

Analytically speaking, the mechanism that appeared time and again in this story was a particular kind of collective action problem. At critical junctures, national governments could

profit individually from what I call “bribing capital”: since financial firms and investors, unless shackled by regulation, are reliably profit-seeking, governments could indirectly command the resources that financial firms and investors controlled, by engineering changes in rules and regulation (or by tolerating questionable novelties, such as the Midland Bank’s financial buccaneering) that rendered profitable whatever activity or outcome the government in question desired. Thus the Bank of England could contribute to a renaissance of the City of London by tolerating the Midland Bank’s arbitrage operations in the 1950s; 1970s New York could boost its financial sector, and hence its own finances, by creating IBFs; the American state could alleviate pressure on its gold reserves and on its domestic system of financial regulation by refusing to extend Regulation Q to offshore dollars; and the French state could foster non-inflationary borrowing through deregulating its financial sector, thus reducing the need for austerity in difficult times.

This constitutes a classic collective action problem for actors who are committed to the value of democracy: like the combustion of fossil fuels, each individual act of attracting financial resources through bribing capital channelled energy to what was perceived to be a worthwhile goal; but across many such acts, the collective consequences were devastating, for their sum was the evisceration of democratic control over the division of labour. Over time, they created an economy whose future structure and whose macroeconomic condition largely depended (and continues to depend) on the decision-making of private capital investors, banks, asset managers, and other financial firms.

Three points bear highlighting here. First, this transformation was not wrought onto national governments by powerful banks and corporations. Instead, even though they were broadly speaking democratic, it was the national governments *themselves* who decided it was in their interest to take the individual steps that led from Bretton Woods to Neoliberal Globalism (Helleiner 1994).

Second, once a sizeable international financial market had been re-created (i.e. controls on outflowing capital had been lifted or circumvented in key states, esp. the US & UK), states could access large amounts of non-inflationary additional resources (which could then be used for whatever domestic project the government of the day deemed valuable) through capital-attracting reforms. This explains the temptation of financial deregulation even for (social-) democratic states: in any particularly tough conflict, a bout of financial deregulation could be used to break the impasse, by channelling additional resources attracted through bribing capital to the relevant veto player, without having to tax another party to the negotiations at the same time. Zero-sum problems or, in the case of the unexpected growth slow-down of the 1970s even negative-sum problems, could thus be transformed into positive-sum (or less harshly negative-sum) ones, rendering them more amenable to bargained resolution. Of course, the perceived positive sum relied on a temporal illusion: the additional resources that turned zero- or negative- into positive sums were cheques written on the future. Eventually, these cheques would be cashed, either out of future growth, necessitating that its fruits would fall to the financial sector, or, if future growth did not suffice, through austerity and upwards redistribution.

Third, the effects of such acts on *other* governments did not depend on the motivation or the internal processes of the government in question. The UK was a democracy in 1955, when the Midland Bank began its arbitrage operations and the Bank of England looked the other way. The government, even though Conservative, was firmly committed to the recently expanded tax- and welfare state. As far as I am aware, neither the Conservative government nor the Bank of England had any intention to undermine US domestic financial regulation, let alone specifically to empower Wall Street at the expense of Washington, D.C. And yet, the Bank of England's decision to let the Eurodollar market grow *did* put pressure on Regulation Q,



setting off the process that would eventually erode the New Deal system of US financial regulation.

Similarly, the United States in the 1960s and 1970s was a country committed to both stringent financial regulation at home, and capital controls on onshore dollars; but, as we saw, it strategically looked the other way concerning offshore dollars, allowing an international dollar market to re-constitute itself in London, despite domestic capital controls in the US. As a result, foreign firms and governments financed US current account- and budget deficits through holding dollars, which put pressure on other governments (including the French) who now had to compete with the attractive terms offered on Euromarkets if they themselves wanted to attract foreign capital.

Germany, lastly, ran a deliberate undervaluation regime from 1951 on (and continues to do so today), centred on competitive disinflation (Blanchard and Muet 1993). Through forcing export surpluses, this forced (and forces) other countries into a structural balance of payments deficit. Since such deficits could only be financed through borrowing abroad or the sale of asset to foreign investors, neither of which can proceed indefinitely, this eventually forces Germany's trade partners into a choice between dropping commitments to full employment (to reduce domestic purchasing power and hence imports), or erecting trade barriers (to reduce imports without domestic austerity). But even though its effect was to undermine Keynesian-Social Democratic settlements abroad, Germany fell into this regime as the result of strategic interaction between the country's central bank, its export industry, its trade unions, and its political parties, and not as a result of capitalists dominating the political process (Höpner 2019). As in the other cases, the particular domestic coalition that produced (and continues to produce) this regime was irrelevant for its effect on trade partners: even though capitalists did not dominate the decision-making process on their own, Germany

became (and remains) the “nightmare of [workers in] the eurozone and, even more, the world economy” (Höpner 2019, 2).

In other words, regardless of the internal decision-making procedure that gave rise to acts of bribing capital, the consequences for other governments were that, if they wanted to attract or even just hold on to footloose capital, they had to match or exceed the terms of this bribe. A race to the bottom, or more accurately, a beauty pageant in which investors and banks sit as the jury, resulted.

These three points explain why democratising firms is not enough to democratise the division of labour. Where bicameral firms are embedded in deregulated financial markets, even bicameral firms will, from time to time, decide to bribe capital. In particular, because financial markets shift resources quickly—there is no need, unlike in product markets, to build them up through many profitable transactions over time—even a firm that does not prioritise profits will be tempted to offer attractive terms to financiers (where financiers have discretionary control over large amounts of capital) in order rapidly to attract resources to whatever project their two chambers deem most worthy of investment.

The impact on other bicameral firms will be that, if these other firms want to undertake significant investments themselves, they either need to optimise their own operations for profit (so to generate the required financing internally, akin to Germany’s undervaluation regime), or they themselves need to “bribe capital” (now via conditions at least as attractive as those offered by the hypothetical first mover, for example the Midland Bank), in order to attract outside funds. In this manner, a process is initiated through which, across many iterations, the judgements of capital providers (in the case of external financing) or the criterion of profitability (in the case of internal financing) end up dominating the decision-making even of bicameral firms—even if none of the firms intended this outcome.

In this manner, the sum of many small bribes to capital, and many small profit-increasing changes to operations, narrows the scope for democratic self-determination over time, through increasing the pressure on other firms to be financial market-conforming, or to optimise their profitability in product markets. Just as this process led the US, the UK, France, and Germany, as well as other advanced democracies, to abandon Bretton Woods and the Keynesian-Social Democratic settlement, similar pressure would likely lead bicameral firms to mimic capitalist corporations over time.

### **Synergies between democracy in the firm and democracy in finance**

How can this process be arrested? How can democratic control over the division of labour as a whole, and in particular over its development over time, be assured?

Democratising financial corporations themselves is unlikely to solve this problem. Two outcomes can be imagined: the sociology of finance suggests that a large number of financial service workers internalise the goal of profitability. If so, even bicameral banks and financial firms would remain receptive to bribes to capital, so that the collective action problem would remain in place.

Alternatively, if the introduction of bicameralism were to change the culture of financial firms, the collective action problem would be solved, but at the cost of introducing new inequities. In particular, firm-level democracy in contemporary economies would then still leave the financial sector as a whole in charge of capital allocation. While this power would then be exercised in a discretionary fashion, as opposed to being exercised in pursuit of profit only, it is not clear why the workers of this sector, who constitute no more than 1-2% of the population, should wield this power over all other citizens. By rendering bribes to capital less predictably effective, this would break the collective action problem mechanism, but it would do so at the risk of creating a financial “labour”-aristocracy, a “bankers’ democracy”.

If democratising financial corporations does not solve the problem, or solves it only at the cost of creating a “bankers’ democracy,” what could be done instead? In accordance with the “all affected” principle, the financial sector as a whole could be subjected to control by the demos as a whole. Proposals along these lines have been advanced by Malleeson (2014), Hockett (2019), and Block (2019).

Practically, democratising finance consists in two steps: first, harnessing financial flows, so they can be required to follow a compass other than pure profitability. Second, ensuring that the thus-created control is exercised democratically and sustainably. Block’s proposals have certain shortcomings on the first dimension,<sup>28</sup> Malleeson’s on the second,<sup>29</sup> but Hockett’s proposals appear, on the basis of their current elaboration, to achieve both.

First, concerning the harnessing of financial flows, through offering citizens and firms direct access to checking accounts at the Federal Reserve (“Fed Citizen and Resident Accounts”, Hockett 2019, 518–19), it ensures that financial flows can be guided effectively. This is because Federal Reserve deposits, in virtue of their 100% security, would attract large amounts of corporate and private money away from private deposit institutions. This brings

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<sup>28</sup> The heart of Block’s proposal are non-profit credit unions and public investment banks. The main problem with these is how to ensure that private funds don’t simply flow around these non-profit institutions. In particular, there were and are plenty of non-profit financial institutions in existence already, but insofar as they offer lower rates of return than profit-oriented banks, they have remained marginal. In addition, in the case of US credit unions and German Sparkassen, it is not obvious that, when embedded in a market together with for-profit institutions, they will behave as desired. As Malleeson shows, US “credit unions actually make a higher proportion of their home mortgages to richer people than comparable private banks,” presumably to generate a margin that allows them to go into higher risk lending to poorer households, showing the structural constraint that they are under (Malleeson 2014, 182). As a result, middle-class borrowers are not always well-served by them. German Sparkassen, in turn, were heavily invested in mortgage-backed securities prior to 2008, since these appeared to offer better returns than lending to local firms or households. Another part of Block’s proposal, however, is more promising: targeted loan guarantees (Block 2019, 545), which allow effective credit guidance in a manner similar to Hockett’s proposals.

<sup>29</sup> Because Malleeson’s proposal, drawing on Schweickart (2011), abolishes private banking (Malleeson 2014, 153), it runs the risk of leaving even very high-return projects unrealised, if they are politically unfavoured. There is no safety vent, so to speak, which would allow citizens’ votes in product markets to correct decisions made in the financial system. Were the financial system to become corrupt—a possibility which Malleeson is aware of, and to which he proposes various counter-measures—pressure would likely emerge to “depoliticise it.”

financial flows under public control and allows them to be harnessed towards publicly desired ends.

Second, concerning the democratic and sustainable exercise of the thus-created control, note that, under Hockett's proposals private banks<sup>30</sup> could still pursue lending and investing that is not approved by the Fed, as long as this is sufficiently profitable to allow the bank to pay an interest rate that offsets the greater risk attached to depositing money there (presumably in time deposits, not demand deposits) as opposed to in a Fed account. This creates a safety vent that signals when public lending neglects projects that, according to the dollar votes cast by citizens in product markets, are widely desired by the citizen body. In this manner, it renders public control over the financial system more sustainable in the long run.<sup>31</sup>

How would this kind of financial system interact with bicameral firms? Although this is a complex question, a robust answer to which requires seeing their interaction play out in the real world, it appears as though there would be strong synergies. Recall why the US government, the single most important actor in the preservation and eventual abandonment of the Keynesian-Social Democratic settlement, did not clamp down on Eurodollars: because looking the other way kept US banks quiet, alleviating their pressure on domestic financial regulation. If bicameral firms are less aggressive about pursuing profits, an eminently reasonable assumption, then the pressure they would exert on profit-inhibiting regulations (whether financial regulation, which this paper has focussed on, or social and environmental regulation, which are equally central in directing markets toward democratically desirable outcomes) would be reduced. While any individual bicameral firm may, through some

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<sup>30</sup> Though it may be more accurate to call them asset managers here, for they would no longer be able to create or manage deposits unless it is for lending approved by the Fed.

<sup>31</sup> As with any proposal that moves in the direction of full reserve banking, there are questions about macroeconomic stabilisation—with endogenous money creation ruled out, the mechanisms behind aggregate demand fluctuations change significantly—and about who then makes lending decisions and how, but these problems do not seem *prima facie* insurmountable.

contingent constellation, happen to go for aggressive profit maximisation, since other bicameral firms would be less likely to copy this than profit-maximising firms would be (esp. if they are backed by a financial sector that only gives mild preference to the profit-aggressive firm, as opposed to flooding such a firm with capital, as a purely profit-maximising financial sector would), this pressure would propagate less quickly. In this manner, democratised firms would be less likely to undermine democratic control over the economy as a whole, and hence stabilise democratisation in finance. In their protective effect, democratised firms thus resemble Regulation Q.<sup>32</sup>

Conversely, a democratised financial sector would stabilise firm-level democracy. As the historical parts of this paper have shown, democracy at the level of individual islands can be hollowed out, even if all important islands are democratised and if no individual island intends this, if small surrenders of control are capable of attracting large amounts of capital. Insofar as a democratised financial sector would be less responsive to attempted bribes of capital, since much of capital would no longer be deployed in pursuit of maximum profit, this mechanism would be rendered inoperative or at least greatly weakened and slowed down.

Democratising finance and democratising firms thus strongly support each other.

### **Conclusion: firms, finance, and democracy in the division of labour**

Ferreras' work highlights the importance of firms in our division of labour. Since markets are practically never perfectly competitive—due to the existence of multiple equilibria, frictions and transaction costs, economies of scale, externalities, and other features—firms have considerable discretion in their decision-making. Moreover, as Herbert Simon pointed out, a hypothetical alien visiting earth, “equipped with a telescope” through which “firms reveal

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<sup>32</sup> Recall that the purpose of Regulation Q was to reduce competitive pressure on banks, so to prevent individual buccaneers whose actions erode existing regulation from being overly favoured by the competitive process. Insofar as democratising firms reduces their profit-hunger, it reinforces and supports Regulation Q (and similar measures in other countries, like the *encadrement du credit* in France).

themselves, say, as solid green areas” and “[m]arket transactions show as red lines connecting firms”, would see a world of “large green areas interconnected by red lines”, not “a network of red lines connecting green spots” (Simon 1991, 28). Firms, in other words, dominate much of economic decision making. Of the problems and inequities that we face today, many are rightfully attributed to firms and their internal decision-making.

And yet, green blobs live in the shadow of red lines. Because firms, despite their market power, are subject to hard budget constraints, their internal behaviour is strongly shaped by the external ecosystem they face. Where finance is deregulated and large pools of footloose capital swirl around the world, firms (and countries) who (credibly) promise pliancy and high returns to finance can command immense resources, giving them a leg up in competition. Over time, finance-pleasing firms can use this to outcompete their rivals, who, due to the hard budget constraint they face, must eventually adapt or perish. Democratising the internal governance of firms may slow this process down, but on its own, it will not arrest it. To render firm-level democracy sustainable, finance must be democratised, too.

The work of Hockett, Block, Malleson and others provides convincing answers for doing so. As I show above, democratising finance is not only compatible with democratising firms, but the two reforms mutually support each other. Does this mean that these changes suffice, in combination, to durably democratise control over the division of labour?

Not necessary. At least three large questions remain: first, the problem of ossification, or, from a market perspective, “inefficiency.” Firm-level democracy under current conditions does not appear to inhibit productivity (Malleson 2014, chap. 3; Jäger, Schoefer, and Heining 2019). But it is unclear how robust this result is: hitherto, democratised firms have always operated in ecosystems dominated by profit-maximising, non-democratic firms, and in the context of financial markets where capital is overwhelming allocated according to profitability. We do not know, therefore, if *the combination* of democratised firms and democratised finance

would *also* be secure against ossification and inefficiency. The very purpose of democratising finance, after all, is to render firms' access to capital less sensitive to pure profit maximisation. This does not dispel budget constraints, but it does not exactly harden them either. The question of dynamism and efficiency over time therefore remains open.

Second, the proposals so far have focused on democratising a division of labour in one country. But recall the second reason why the US failed to clamp down on Eurodollars: namely worries about foreign firms and governments selling their US dollars or converting them into gold, which had become a problem because the US went from trade surplus to trade deficit. In other words, international imbalances can undermine domestic democratic control. Deficit countries face a tough choice: clamp down on domestic demand, grow your exports (this often means cutting wages), or borrow and sell assets abroad.<sup>33</sup> Insofar as austerity (whether to cut imports or to boost exports) may not find domestic majorities, foreign debt may build up, which in turn creates pressure to reform in a capital-pleasing direction. How to prevent the building up of international imbalances is hence a key open question for sustainably democratising the division of labour.

Finally, there remains the question of mergers and acquisitions, of firms splitting and re-combining, and of the market for corporate control. Industrial firms, for example, used to employ cleaning, catering, and other non-manufacturing workers directly, at wages and conditions comparable to their core workforces. Under cost pressure, these have either been outsourced; or, where firms did not aggressively profit-maximise in this way, private equity firms purchased such companies, "streamlined" them, and then sold them off again at a profit.<sup>34</sup> In this manner, M&A can be another mechanism that puts pressure on firms to be

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<sup>33</sup> This latter option will be facilitated by the fact that the surplus countries need a place to invest their surpluses.

<sup>34</sup> Indeed, a large part of the increase in inequality has been driven by *between-firm* inequality (e.g. all lawyers in a law firm now earning much more than the food workers in the catering company that serves the law firm) rather than *within-firm* inequality (e.g. the CEO of a firm earning 300 times the median or average salary of the same



profit maximising, again constraining the scope for firm-level democracy to permit real agency and substantial deviation from how a non-democratic, profit-maximising firm would behave. How to regulate M&A is thus a third and final open question in the great task of democratising the division of labour.

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firm) (Song et al. [2018](#)).

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