Honors Theses (PPE) Philosophy, Politics and Economics

4-23-2013

The Goals of Finance and their Instrumentality in Democratizing Wealth

Anna M. Whiteman

The Goals of Finance and their Instrumentality in Democratizing Wealth

Abstract

Over time, individuals have used tools of finance to increase their own personal and familial holdings, to seek education, and to begin gaining equity stakes in their own homes, among other pursuits. Corporations have used finance to capitalize new business ventures, to provide funds for investment in research and development, and to expand into new markets. Finance, through its various instruments and practices, has thus enabled people to make manifest their ambitions and has allowed creative ideas to flourish in competitive markets. Finance, in essence, serves as the organizing principle that provides for vigorous economic activity and wealth generation in societies where it functions properly and, as such, "it can be used to help broaden prosperity across an increasingly wide range of social classes." Given this capacity to broaden prosperity for all, finance should be used as a tool of wealth democratization if it is to stay true to its terms of original instantiation.

Keywords

Finance, Democratization, Wealth, Income, Equality, Equity, Society

Disciplines

Business Law, Public Responsibility, and Ethics | Economic Theory | Finance | Finance and Financial Management | Income Distribution | Organizational Behavior and Theory

The Goals of Finance and their Instrumentality in Democratizing Wealth

Senior Honors Thesis
Philosophy, Politics, and Economics Department
Anna McGinley Whiteman

Advised by Professor Waheed Hussain
April 23, 2013

I. Introduction

The institution of finance exists in principle to facilitate access to capital such that people or firms may ultimately realize their individual ambitions, and society, in aggregate, can benefit from the realization of these ambitions. More precisely, as John Boatright illuminates in his book *Finance Ethics*:

> "finance may be defined broadly as the generation, allocation, exchange and management of monetary resources…[The activities of finance] are facilitated or mediated by a variety of financial *markets* and financial *institutions*, such as securities and commodities exchanges, commercial and investment banks, insurance companies, mutual and pension funds, and the like. In addition, finance includes the academic subject called finance that is studied in business schools and constitutes the training that people in finance – both scholars and practitioners – receive."[1]

Over time, individuals have used tools of finance to increase their own personal and familial holdings, to seek education, and to begin gaining equity stakes in their own homes, among other pursuits. Corporations have used finance to capitalize new business ventures, to provide funds for investment in research and development, and to expand into new markets. Finance, through its various instruments and practices, has thus enabled people to make manifest their ambitions and has allowed creative ideas to flourish in competitive markets. Finance, in essence, serves as the organizing principle that provides for vigorous economic activity and wealth generation in societies where it functions properly and, as such, "it can be used to help broaden prosperity across an increasingly wide range of social classes."[2] Given this capacity to broaden prosperity for all, finance should be used as a tool of wealth democratization if it is to stay true to its terms of original instantiation.

[1] Boatright 3
[2] Shiller 9

Four principal human values that motivate institutional finance are self-determination, efficient allocation, fairness, and long-term growth. Self-determination allows individuals to explore their passions, develop their talents, and construct individual lives that they deem worthy of pursuit. Efficient allocation ensures that scarce assets are utilized as resourcefully as possible, ultimately in service of the greatest number of people at a minimal cost to society. Fairness, a fundamental human impulse, as translated through the market, confers to each individual or corporation a payoff that suitably compensates the scale of his or her contribution.[3] Long-term growth guarantees that investments that we make today, whether in the individual, in corporations, or in capital funds, will help us flourish sustainably in the future. Finance, a manmade tool developed to satisfy these human pursuits, should be consistently oriented towards their realization. Products, such as investment vehicles or loan policies, should be engineered to give users greater self-determination, provided that these users themselves abide by proper rules of play. Financial markets, in which countless actors conduct scalable transactions each and every day, should intrinsically seek long-term growth by distributing resources competitively and fairly. In order for market actors to reap the future benefits of today's financial transactions, these markets must rightfully capitalize those endeavors that will constitute our tomorrow. A financial setup that prioritizes the principles of self-determination, allocative efficiency, fairness, and long-term growth perspective aligns with a well-understood concept of finance. Finance has a

[3] Boatright 167

social responsibility to pursue these human goals so that it can generate and distribute substantial wealth.

While society at large would prosper from the proper conceptual functioning of financial markets, opportunities do arise that allow smaller entities, either individuals, corporations, or financial institutions, to deviate from their social responsibilities in pursuit of short-term profit. These actors' deviations, compounded over time, have managed to undermine the initial principles of self-determination, efficient allocation, fairness, and long-term growth that underlie finance. Deviations arise from the fact that financial institutions themselves, the "gatekeepers" of monetary resources, have been improperly constructed with incentive structures premised around short-term profit generation. Managers of corporations large and small, for example, are currently evaluated on a myopic basis, with CEO compensation determined by quarterly or annual production figures rather than on their ability to create long-term value. As a result, companies guided by these improperly incentivized managers seek daily returns at the expense of the companies' future growth. In this context of misdirected financial institutions, the ultimate goals of finance, self-determination, efficient allocation, fairness, and long-term growth, are obfuscated at a great cost to society.

The misdirection of modern financial structures and incentives has manifest social consequences. Self-determination in this context for the individual is granted only insofar as an investment in the individual will generate immediate kickbacks for lending institutions. Efficient allocation cannot properly locate the companies that will constitute our tomorrow because these companies' investments in research and development or human capital, so critical for their steady growth in a competitive economic environment, are not reflected as quarterly returns on a balance sheet. Fairness becomes an impossible dream, as the gatekeepers of capital amass wealth through their positions of power and the lower portion of the socioeconomic spectrum grows at a much slower pace. This wealth inequality then only compounds over time, drawing finance farther and farther away from its conceptual premise. Perhaps most blatantly brushed aside by this flawed institutional setup is the pursuit of long-term growth. Operating on such a myopic basis, many firms and companies become naively willing to dismiss those policies that have proven to generate value over a longer time horizon, such as strong corporate social responsibility platforms, in favor of practices that simply inflate daily share prices. The deviations of actors, corporations, and firms, however, are not inevitable and can be addressed to align finance more intimately with its fundamental goals. Irresponsibility of financial institutions can be corrected from within by revised incentive structures and altered accountability practices within firm hierarchies. It can be further addressed externally by limited but directed political regulation that preserves the competitive market nature of the financial industry while impelling each individual firm to accept an obligatory social responsibility. Such high level corrections could begin to clarify the philosophy that guides financial institutions, pointing them towards long-term value creation rather than short-term rent seeking. By addressing those institutional policies that compel financiers and financial institutions to act in ways counter to the goals of finance, we can thus begin to synchronize the conceptual ideals of finance with its day-to-day practice.

II. Understanding the Scope, Intent, and Responsibilities of Finance

1. Conceptual Finance

Conceptually, finance consists of the institutions, mechanisms, practices, and individual and collective actors operating to protect, direct, and allocate society's assets. These institutions and actors ideally will seek to channel resources to growth-oriented prospects or, alternatively, will allocate capital that produces some present benefit for one individual or entity while generating a future return on the present investment for another entity. Products and practices of finance, such as the home mortgage or a company's initial public offering, will thus contribute to the growth of society's assets over time, while channeling money and capital into those areas of development with the highest expectation of future success and investment payoff. Robert Shiller, in his book *Finance and the Good Society*, explains that as a prerequisite to financial contracting,

> "all parties to an agreement have to want to embrace the goal, do the work, and accept the risks; they also have to believe that others involved in the deal will actually work productively toward the common goal and do all the things that the best information suggests should be done. Finance provides the incentive structure necessary to tailor these activities and secure these goals."[4]

This characterization of finance embeds critical assumptions about parties who seek to engage in financial contracts in a social context and, in doing so, presupposes certain social behaviors and outcomes that result from the successful functioning of financial institutions. Individuals in society can use finance as an outlet of self-

[4] Shiller 8

determination, provided they feel reasonably assured that those financiers with whom they contract have their best interest, and personal success, as a mutual end goal. Firms looking to grow their market share can use the tools of finance and the expertise of financiers to efficiently underwrite their enterprises, giving them expectations of optimized returns which they can then use to further innovate in a vibrant economy. Additionally, finance can serve as a mechanism of market fairness. It can provide non-discriminatory capital to individuals and corporations across the socioeconomic spectrum while still maintaining an economic structure propelled by competition. Finance, under Shiller's definition, is able to synchronize the goals of multiple social parties into a mutually beneficial agreement, producing gains for both parties involved should they fulfill proprietary contractual expectations and obligations. These mutual gains, over a long-term time horizon, should thus usher in expectations of economic growth and, if properly managed, wealth democratization.

More latent in Shiller's characterization of finance as the economic backbone of social contracting are the consequences of deviant behavior by one or both of the parties to a financial contract. As Shiller points out, finance is an institution structured by incentives, which can produce absolute gains if incentives are balanced properly. However, should either party to a financial contract deviate from its obligations in pursuit of short term profit, this incentive structure is thrown off balance at the expense of the financial arrangement's long term success. Empirically, this can translate into the misallocation of otherwise growth-oriented capital into the hands of a less deserving party, which result detracts from long-term economic development. This deviant behavior, which so saliently depicts the face of modern finance, stands in opposition to a conceptual definition of the institution and will be explored here in greater depth.

1a. Self-Determination

On an individual basis, the tools of finance should allow people in society to access liquidity, manage their personal and familial wealth, and allocate their resources towards those actions and assets that they believe will enhance their own quality of life. Such tools historically have included mortgage loans, student loans, trust funds, and individual retirement accounts, among others. These tools are ideally intended to give individuals in society the opportunity to lead higher quality lives pursuing activities and causes that they believe to be meaningful or pleasurable. It has become clear over time that in order to organize social behavior in market environments, align individuals' shared personal and social goals, and make resources consistently available for the individual achievement of these goals, it is necessary for sophisticated financial institutions to exist.

Financial institutions were indeed borne of the necessity of individuals to obtain access to capital to satisfy personal desires and ambitions. Since their first primitive manifestations as small-scale collateralized lenders in ancient Greece and Rome, financial institutions have been in the business of facilitating gains from trade on an individual level. As Shiller makes apparent in his chapter *Categorizing People: Financiers versus Artists and Other Idealists*, finance is a necessary component of any and all social endeavors involving contracting individuals, irrespective of the field or industry within which they are contracting. Using the example of "two of the world's most highly regarded – and highly priced – contemporary artists, Jeff Koons and

Damian Hirst," Shiller explains that both artists "…are not just solitary artists; they are both financial sophisticates. Both run businesses with numerous employees, and both are aggressive marketers of their own works."[5] In order to successfully pursue certain passions, as Shiller notes, it is necessary to recognize the instrumentality of financial markets in bringing idiosyncratic endeavors to scale. To further the example of successful artists, while the artists themselves contribute the central creative and thoughtful dimensions of their works, finance supplements the production process by locating investors in these works, providing the funding necessary to complete the works, and organizing markets to keep the art trade functioning efficiently and lucratively. Although these considerations often lie in the background, they are no less imperative for the scalability and sustainability of world art markets. Extrapolated to individuals working in diverse trades throughout the world, or pursuing a range of dreams, from home-ownership to higher education, finance consistently plays a role in bringing individual pursuits to fruition. As a means to each individual's pursuit of that which they believe constitutes a life worth living, then, finance has both great power and great responsibility.

1b. Efficient Allocation

On a broader corporate basis, the tools of finance should be used to allocate capital provisionally to those companies whose ideas, business models, and use of capital suggest successful future growth and proliferation. Whether this success is measured through metrics such as return on investment, corporate longevity and

---

[5] Shiller 136

sustainability, or employment opportunities that a company could present to its hosting community, those businesses that receive capital injections should possess fundamental and intrinsic value that will utilize granted capital most effectively. Over time, as business needs evolve and demands change, financial products suited towards capitalizing these needs should, in a well-developed financial market with proper accountability standards in place, be able to respond with apt flexibility and minimal risk. Structured products of various sorts, predominantly debt and equity lending, can then allow growing, mature, or even struggling businesses to finance their set-up, operational, and expansionary needs. Conceptually, the results of these corporate financing activities come in the form of increased employment, enterprise profitability, continual business innovation and healthy market competition, among others.[6]

Financial institutions such as banks, pension funds, private equity shops, asset management firms, and community lenders, among others, each has an obligation to allocate capital efficiently if they hope to serve their specific social function. These institutions, according to Shiller's characterization of finance, represent the "stewards" of society's assets, helping to match investors with creative investment opportunities, moving large pools of capital into long-term growth projects or investment funds, and providing the capital and advisory services needed to bring aspiring business ventures to scale. The profits that these institutions generate from their business activities, ideally, will represent a fraction of the growth that they help to create in the broader economy as a result of their

[6] Rajan and Zingales 108

operations.[7] Provided these institutions follow proper corporate governance procedures, financial institutions' profits should be contingent on broader social prosperity, riding the same waves of economic growth and stagnancy as the rest of society does (although the correspondence of these two outcomes was most recently called into questiong during the 2007 crisis in which global economic markets violently contracted while financial institutions' profits remained steadily on the rise). Even those who subscribe to the profit-driven shareholder theory of the firm admit that there is social wealth to be generated through this form of cooperative capital allocation. As Boatright reiterates in his chapter *Ethical Implications of Finance*, "the goal of capital budgeting is to find and invest in projects that increase the value of the firm in general and, more specifically, increase shareholder wealth, or equivalently, the price of the firm's shares…However, it should be emphasized that firms that undertake profitable investment projects contribute to the wealth of society and this is a major contribution of business to societal well-being."[8] Even in the competitive context of shareholder theory, finance is expected to raise the overall level of social wealth while efficiently allocating capital according to market demand. In moving capital where it can be most

[7] Rajan and Zingales help to establish this fundamental relationship between developed financial markets and economic growth, concluding from multiple studies that "…few would now doubt that there exists a causal link between the development of the financial sector and the growth of the economy…Finance cannot create opportunities, but it makes it easier to exploit them: what it can do is identify the areas of opportunity and decline, and achieve a better match by giving to sectors with a future while taking away from those with only a past." (Rajan and Zingales 113)

[8] Boatright 32

productive, finance properly guided can help to foster innovation in business, create jobs, and raise the socioeconomic bottom line.

1c. Fairness

In addition to being vehicles of self-determination and efficient allocation, financial markets also have a responsibility to be fair distributors of capital over time. In order to be fair, markets should be open and equally accessible to each member of society so that any individual or corporation, regardless of initial position or context of origin, has equal opportunity to take advantage of the benefits of financial markets. As financial markets develop over time, they have a tendency to perpetually allow wealth to accrue to a class of elite citizens, a consequences that has the effect of unfairly restricting a wide swath of society from accessing finance's intrinsic benefits. As Rajan and Zingales recognize in their book *Saving Capitalism from the Capitalists*, the economically powerful in developed financial markets have incentive, and the necessary power, to keep markets working in their favor so that they may reap disproportionate economic and financial benefits at the expense of others in society. In direct conflict with this pattern of accrued advantages, the principle of fairness in the context of financial markets requires that "we should honor claims in proportion to their strength…we can assert that fairness at both a substantive and procedural level involves…the proportional satisfaction of claims *existing prior to the making of rules, agreements, or expectations.*"[9] This definition makes clear that pre-existing advantages, which can come in the form of inherited assets, greater access to educational opportunities, or even broader exposure to

[9] Boatright 167

potentially lucrative career paths, should have no bearing on the probability that an individual or a firm can achieve personal or corporate "success" in society.[10] While this definition does not imply that income inequality per se is harmful, it does imply that economic inequalities should be consistently checked so as to not create a generational legacy of increasing social stratification. To this end, financial markets can regulate themselves to satisfy the criterion of fairness. Rajan and Zingales agree that, "given the right infrastructure…financiers can overcome the tyranny of collateral and connections and make credit available even to the poor. They become a power for the good rather than the guardians of the status quo."[11] Such parameters of fairness, wherein individuals are encouraged to pursue their creative ambitions and can hope to be rewarded (or punished) adequately, will ultimately contribute to a vibrant economic and social structure undergirded by sustainable financial foundations.

Fairness as a distributive principle is often depicted as mutually exclusive with the concepts of efficiency and profit maximization and thus can obscure the theoretical aims of financial institutions. As Eugene Heath describes, however, in his chapter *Fairness in Financial Markets* regarding the responsibility of financial institutions with respect to fairness:

> "an appeal to efficiency provides a valuable reminder that the legal and regulatory framework of bank lending should provide the conditions for productivity. However, the value of this sort of analysis does not vitiate the importance of moral considerations such as those of fairness. A normative or moral evaluation of businesses and markets examines commercial practices in terms of their foundational principles or in terms of the operations and interactions that arise once these principles are set in place. The concept of

[10] Boatright 167
[11] Rajan and Zingales 43

> fairness, for example, may be invoked to consider the foundational framework of markets as well as the rules and regulations of ongoing exchanges…"[12]

According to Heath, although fairness is not a necessary component of properly structured financial market, it may be used as an important criterion against which to judge the morality of markets. Insofar as we should strive for markets to espouse a principle of morality, they should thus be continually judged by a strict standard of fairness. If financial markets are disproportionately conferring profits to the wealthy, through executive compensation schemes or discriminatory credit extensions as a result of preconceived expectations, then broadening social stratification will consistently result as a byproduct of these markets. Wealth inequalities will compound and exacerbate to the point of market collapse. Should fairness become a priority of financial market actors and institutions, wealth could be created on a broader scale, conferring the benefits of financial institutions to the many rather than to a select few.

1d. Long-Termism

Perhaps the most fundamental normative principle underlying personal, corporate, and public finance is the pursuit of long-term growth. Individuals looking to accumulate resources to pass on through their families, corporations seeking sustainability, and governments looking to mitigate future resource risk all can rely on tools of finance to enhance their long-term prospects for success. Unfortunately, short-term profit maximization generally precludes long-term value creation, though short-termism has seemingly become the status quo for rational activity in

[12] Boatright 163

financial markets. As Michael Jensen of the Harvard Business School argues in his paper *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, "short-term profit maximization at the expense of long-term value creation is a sure way to destroy value…[the implications of this are] that we must give employees and managers a structure that will help them resist the temptation to maximize short-term financial performance (as typically measured by accounting profits or, even worse, earnings per share)."[13] Value, according to Jensen, may be captured most efficiently through strategies of long-termism: investing in a strong corporate social responsibility platform, funding research and development, and integrating intangibles such as customer satisfaction or employee welfare into financial metrics. With the proper distributive mechanisms in place, this wealth can help serve the purposes of self-determination, efficient allocation, fairness, and long-termism that also underlie normative finance.

1e. Meeting Finance's Goals in a Competitive Market Economy

Though finance, by design, should honor the ideals of self-determination, efficient allocation, fairness, and long-termism, financial firms' pursuit of these values often seems to erode their individual competitiveness. Can we design a competitive system in which institutions can realistically translate an individuals' right of self-determination into a long-term profit maximizing business objective? Are resources not allocated properly to produce the highest possible return on investment if a firm decides to donate to a community non-profit rather than placing its capital into a promising new business venture? As Forest Reinhardt and Robert

---

[13] Jensen 16

Stavins of the Harvard Business School and the John F. Kennedy School of Government at Harvard University respectively note, firms' commitments to their social obligations do not necessarily beget substantial profits in an imperfectly competitive economic landscape: "in the real world of asymmetric information and oligopoly, the evolutionary mechanisms that might be thought to preclude firms from engaging in profit-sacrificing behaviour are not always effective. If their managers want to sacrifice profits to promote what they see as the public interest, they may be able to do so as long as one or more of their input or output markets is imperfectly competitive."[14] Accordingly, firms can expect to generate reasonable profits while still prioritizing social obligations such as individual self-determination and fairness. The profits may reflect the value that customers ascribe to a firm's commitment to its core social responsibilities.[15] Or, through providing individuals with fair mortgage loans or flexible student loan policies, firms can command customer loyalty and incentivize reciprocity to build their customer base and lower loan default rates, both profit-enhancing strategies. Similarly, although a donation to a local non-profit might seem to cut directly into a firm's bottom line, the reputational kickback may have the effect of improving the firm's overall

[14] Reinhardt and Stavins 5

[15] Profits may come in the form of customers deliberately deciding to stay loyal to a firm even in a context of perfect price competition because the firm seeks to operate in the individual customer's best interest or it pursues long-term value creation through strategies such as CSR; or, if enough firms decide to pursue social objectives through their operations so as to set an industry standard, the cost of capital could be raised for non-compliant firms to the point that their abstinence forces them to lose market share.

perception and future profits.[16] Though pursuit of social obligations might not necessarily be consistent with a financial firm's competitiveness in an efficient market setting, the efficient markets hypothesis' failure to adequately capture the value of intangibles implies that the two pursuits, competitiveness and fulfillment of certain key social obligations, may not be so mutually exclusive after all.

State policy is needed to supplement a firm's independent incentives to fulfill its social obligations. The competitive advantages a firm can accrue by prioritizing intangibles such as individual self-determination and fairness must level off at a certain point, at which juncture firms will begin to see a tradeoff between short-term profit maximization and long-term value creation. It is precisely at this point where governments must regulate the actions of financial firms so that they can continue to be competitive and profitable without forgoing their social responsibilities. As Franklin D. Roosevelt reiterated following the Great Depression, a time in which the competitive forces of financiers and financial markets seemed to override our most basic social considerations, "men may differ as to the particular form of governmental activity with respect to industry and business, but nearly all are agreed that private enterprise in times such as these cannot be left without assistance and without and without reasonable safeguards lest it destroy not only

[16] British Petroleum (BP) pursued a similar strategy of profit enhancement through generation of a positive social image with its "Beyond Petroleum" marketing campaign. Ann Hand, marketing chief of BP at the time of the campaign, stated, "we have a shareholder obligation to maximize value and increase sales revenue, but, at the same time, we can deliver great guest experience and build brand loyalty. That creates a win-win situation for our consumers and our shareholders." Whether or not the firm was falsely advertising in this campaign is still contentious but this example illustrates the profit that can be derived from a firm maintaining its positive social reputation (Cherry 1003).

itself but also our processes of civilization."[17] Roosevelt continued by remarking that the corrosive short-term competitive practices of the banking industry, "…in the sale of securities, in the deliberate encouragement of stock gambling, in the sale of unsound mortgages" could be addressed by restrictions on trading practices or new legislation such as the Securities Exchange Act.[18] This regulation, far from detracting from individual firm competitiveness, applied even-handed rules to the conduct of each firm within financial markets that guided them towards their greater social obligations. By increasing transparency in the securities markets, limiting trading arbitrage opportunities, and creating greater oversight of mortgage markets, state regulation during the New Deal helped usher finance in the direction of greater self-determination, efficient allocation, fairness, and long-termism. Though these regulations have been challenged by new competitive strategies arising in modern markets, upkeep of this state infrastructure is necessary to ensure that markets and their component firms remain in the service of their fundamental social goals.

1f. Summary

The pursuit of better ways to achieve simple human goals has always driven finance forward. Finance can serve as an instrument of self-determination by providing individuals with resources to access higher education or mortgages with which to purchase their own homes. Finance can serve as an instrument of efficient allocation by placing capital with the best and brightest ideas, those that will shape our world tomorrow. Finance can serve as an instrument of fairness if it is adequately socially democratized, maintaining a competitive economic landscape

[17] Rajan and Zingales 207
[18] Roosevelt *Fireside Chat*

while giving each individual or business an equal opportunity to realize success. Finally, finance can embed long-term growth into the process of economic development, acting as an agent of value creation rather than a short-term profit machine. Robert Shiller poignantly states, "the goals served by finance originate within us. They reflect our interests in careers, hopes for our families, ambitions for our businesses, aspirations for our culture, and ideals for our society…The better aligned a society's financial institutions are with its goals and ideals, the stronger and more successful the society will be."[19] To the extent that society should strive to be an agent of individual and collective prosperity, and should foster creativity and dynamism through its economic markets, financial institutions should share these goals. Though characterizations of finance today largely focus on the shortcomings of financial mechanics that arise largely as a result of market competition, we must not lose sight of the wealth that finance has the potential to generate. Beyond monetary value, finance can allow individuals to explore their passions, can propel innovative business ventures forward, can raise the socioeconomic bottom line, and can achieve these goals sustainably. Under these conditions, finance can work for the masses, democratizing wealth and promoting the values of a truly "good society."

II. How Finance Has Fallen Short

The modern portrayal of finance as principally beneficial to those working within the boundaries of the financial industry stands in direct opposition to Shiller's characterization of finance as the science behind the achievement of

[19] Shiller 7

mutually beneficial social goals. Nonetheless, specific and proven deviations from the conceptual ambitions of finance by actors in the financial space do make this characterization tenable. Often deviations from the conceptual ideal are a result of competitive market forces rewarding firms and financiers who can maximize short-term profits rather than create longer-term value. As Rajan and Zingales remark, the financial industry, by its very nature, could perversely become a means to preserving the social status quo for those at the top of the economic pyramid through misuse of industry resources. Accordingly, they note that the sophistication of the financial industry causes it to attract workers who have had the ability, time, and resources to become well versed in its subtleties. These workers generally already constitute an economically powerful class upon entry into the financial industry, and as such, seek to control markets and orient them in their favor, although collectively this may entail forsaking the conceptual ambitions of finance. They claim, "the economically powerful are concerned about institutions underpinning free markets because they treat people equally, making power redundant. The markets themselves add insult to injury. They are a source of competition, forcing the powerful to prove their competence again and again. Since a person may be powerful because of his past accomplishments or inheritance rather than his current abilities, the powerful have a reason to fear markets."[20] As this caveat illustrates, empirical finance can deliberately, unfairly stray far from a conceptual ideal as a result of misdirected individual and corporate incentives largely governing the operations of financial markets. Given that finance, and the

[20] Rajan and Zingales 9

proper conduct thereof, holds a prominent position in both individual and corporate social welfare, the empirical facets of the industry must also be explored to locate practical areas for improvement that can help shift the financial industry in line with its broader conceptual ambitions.

2a. Self-Determination

Insofar as finance is intended to serve as an instrument of individual self-determination, there are some severe shortcomings within the financial industry that preclude individuals from being able to pursue their dreams. Higher education is one activity that an individual might pursue, with the financial assistance of a student loan, to enhance one's quality of life and future prospects. Empirically, unfortunately, the student loan financing market has become one of skewed incentives for bankers, investors, and specialty finance lenders, leaving government and taxpayers to shoulder subsequent costs.[21] In deeming certain individuals or institutions credit-worthy enough to merit student loan financing, private financial institutions have recently been able to cherry pick those whom they believe to be most likely to pay back their loans, transferring the riskiest pool of securities into public hands. As one manifesto entitled *Private Student Loan Financing in an Era of Needs and Challenges* in the Institutional Investor Journal advises student lenders:

> "the quality of a student borrower's education can be highly correlated to the ability of that borrower to obtain gainful employment after graduation ultimately impacting loan performance. For this very reason, schools with high federal cohort default rates and those with historically low graduation rates have been under scrutiny…Investors in student loan-backed ABS must now be aware of the profile of the school type distribution within loan

[21] Costs include assuming the risk of less credit-worthy borrowers, having to provide loans at lower interest rates to widen financing availability, and accepting financial responsibility should borrowers default

> pools…The paradigm has truly shifted from a world in which lenders fought to be on each school's recommended list to a world where schools are fighting to be on a lender's approved institution list."[22]

Contrasting Shiller's view of finance as the mechanism that synchronizes debtors' and creditors' goals in pursuit of an overall social benefit, this depiction of the student loan market reflects the relatively subservient position of borrowers to financiers with commanding control of capital. Given that the private side is unwilling to provide funding, even for education, to subprime borrowers in volatile market climates, the responsibility is thus transferred onto government to pick up the financing shortfall. Unfortunately, this structural issue transfers the bulk of default risk onto government and taxpayers, in pursuit of increasing educational accessibility, while allowing private lenders to collect on a more stable stream of loan repayments. This empirical deviation from a fundamental conceptual aim of finance represents an incentive problem within the broader financial industry, through which private financiers can privatize profits while socializing associated costs. It erodes the ability of finance to act as an instrument of self-determination and must be addressed when synthesizing an idealist view of finance with a realist perspective.

2b. Efficient Allocation

A strong institutional relationship between business management and financiers should theoretically promote broad-based economic growth and social wealth democratization. Prevailing data, however, indicates that finance itself through its products and players is overly susceptible to manipulation by the most

[22] Santo 111

powerful private corporations at the expense of emergent market competitors. As Gar Alperovitz admits of our current financial institutions in his book *America Beyond Capitalism:*

> "the truth is, various forms of manipulating the market are central to the operation of the current corporate-dominated political-economic system, not peripheral to it. They come with the territory – as everyone knows full well when they shift their gaze away from abstract theory to the real world of oil company lobbying, drug company political payoffs, Microsoft anticompetitive maneuvering, and Enron corruption…Leaving aside the morality of the implicit choices of the present system, countless studies demonstrate that we currently throw away literally millions of productive people whose contribution to the economy could be enormous."[23]

In noting that market manipulation has become central, rather than peripheral, to the modern functioning of US financial markets, Alperovitz concedes that our financial system is skewed in favor of vested corporate interests. Under such conditions, financial capital simply cannot be matched appropriately to more worthy corporations or business ventures. Rather, it is supplied discriminately to industry giants such as Microsoft with the power to adjust the competitive landscape to suit their own terms. While alternative sources of financing, such as crowdfunding and microfinance, have sought to bridge this critical capital gap for smaller scale "disruptive" competitors, economies of scale cannot effectively be built on these platforms alone.[24] This shortcoming of empirical corporate finance, as Alperovitz additionally notes, comes at the expense of both opportunity and wealth democratization, representing a deviation from the fundamental conceptual ambitions of finance. Such a deficiency, parallel to that of the personal finance

---

[23] Alperovitz 77
[24] Rajan and Zingales 6

industry, must also be addressed when attempting to reform the infrastructure of finance more broadly to service its theoretical goal of allocative efficiency.

2c. Fairness

Financial intermediaries have continually failed to channel resources and opportunities fairly across social classes. This failure has resulted in compounding wealth inequalities over time, restricting economic development and locking potential sources of capital growth. Fairness, wherein an individual's or corporation's claim to financial resources or capital may be satisfied in proportion to its standalone strength, notwithstanding preexisting accumulated advantages, may be gauged through a variety of financial metrics. One such measure of a society's financial fairness is the extent of that society's "financial inclusion." Financial inclusion gauges the accessibility of a society's formal and informal financial resources and measures the degree to which that society compels individuals or firms to take advantage of financial resources. Given that a precondition of fairness may be the extent to which a society grants individuals equal access to financial markets and their associated benefits, broader financial inclusion would correspond with a more "fair" financial market environment. As Rajan and Zingales note, financial institutions' exclusivity bias in lending to those with proven collateral assets, though perhaps financially rational, is also unfair: "the financier will naturally gravitate toward financing the haves simply because they have the collateral or connections to assuage his concerns…should we be concerned [about the bias]? We believe yes, both because the economy cannot produce as much as its potential and because what it does produce is not distributed fairly."[25] Biases in financial inclusion within societies, whether a result of underdeveloped financial institutions or risk mitigation tactics, beyond being unfair, are therefore economically suboptimal. They keep potential sources of great wealth trapped and prompt a vicious cycle of wealth inequality that must be closed if finance is to be considered truly "fair."

In their analysis of financial inclusion within and among various world economies, Asli Demeriguc-Kunt and Leora Klapper of the World Bank's Finance and Private Sector Development Team's findings reiterate the point that financial exclusion leads to unfair wealth distribution. Specifically, they find that those at the "base of the pyramid" are much less able to take advantage of financial services due to cost barriers, access issues, or sheer unawareness of the resources that are available to them.[26] This inability to utilize financial services subsequently constrains this subset of the population's growth potential, resulting in increasing cross-social wealth stratification beyond simple compounding of income inequality. They find that adults who hold formal accounts at financial institutions are more likely to set personal savings goals, receive steady wage payments through these accounts, and build strong credit for future borrowing purposes. The individuals who do not open accounts, in both high-income and developing economies, tend to be those who do not have enough money to commit to their accounts (30%), who

[25] Rajan and Zingales 34-35

[26] Intuitively, financial institutions seek to establish commercial banking branches and financial outlets in those demographic locations where they can guarantee a stable, less risky customer base. This compels riskier populations of customers to resort to correspondingly riskier, and pricier, alternative financing mechanisms.

cannot afford to open the account (25%), or who do not have easy access to commercial institutions providing financial services (20%).[27] The constraints placed on these individuals, most commonly a result of their inherited social position, prevent them from enjoying the same benefits of financial resources as those who constitute the higher end of the socioeconomic spectrum. They are thus less able to grow their personal wealth and must remain seeded at the base of the pyramid while the wealthy are able to further prosper. From this angle, it becomes clear that society has a responsibility to make financial resources available more broadly if each individual is to be truly rewarded in proportion to the strength of their claim. Through making financial resources more accessible, we can ensure that "instead of an aristocracy of the merely rich, we [will be] moving to an aristocracy of the capable *and* the rich…[We will be] putting the human being at the center of economic activity because, when capital is freely available, it is skills, ideas, hard work, and inescapably, luck that create wealth."[28] Under these conditions we can hope to have a system of finance that is truly "fair" to all those who utilize financial services.

2d. Long-Termism

The focus on short-term profit maximization over long-term value creation has perhaps most harmfully derailed modern finance. Myopic compensation schemes, direct accountability to shareholders, and insufficient risk oversight, among other factors, have allowed finance to develop into a "race to the bottom" for

---

[27] Demirguc-Kunt and Klapper 22
[28] Rajan and Zingales 92

profits rather than a constructive social enterprise.[29] As Joseph Heath explains in his chapter *Agency Theory and Self-Interest*, the individual compulsion to act in response to salient self-interests often overrides longer-term considerations of firm wellbeing or value creation. He characterizes such short-termism as "opportunistic behavior," which "…is a direct consequence of agents acting in accordance with the general game-theoretic principle known as *sequential rationality*. This is simply the view that, in a multistage game, a rational strategy must not only be utility-maximizing at the point at which it is chosen, but each of its component actions must also be utility-maximizing at the point at which it is to be performed." Heath concludes from this theory that individuals will consequently "act unreservedly using guile and deceit – not only when necessary, but whenever it is advantageous for them to do so."[30] Accordingly, CEOs will have incentive to "cook the books" to inflate their annual pay packages, supervisors will have incentive to overlook risky bets made by their employees if they seem to provide short-term upside, and individuals who constitute the heart of financial institutions will continue to act opportunistically at the cost of long-term value creation. Short-term opportunistic behavior, many would argue, has actually catalyzed recent events such as the sub-prime mortgage crisis, the collapse of Enron, and the trading scandal sparked by the "London whale," leading to large-scale value destruction at a significant cost to those in society whose welfare depends on healthy financial markets. This behavior, in the long-term, simply cannot comply with a sustainable business or social model.

---

[29] Orsagh 4
[30] Boatright 129

That financial capital is often steered into short-term profit-maximizing ventures can be attributed to the reward structures intrinsic to modern financial markets. Financial analysis, for example, values firms based on metrics like free cash flow, value of physical assets, or dividend payments on outstanding equity. This implies that firms with impressive financial statements today will attract investment while firms committing their resources to intangibles, though perhaps equally valuable, may be overlooked.[31] In the short-term, it is these firms with strong tangible financials that will seem to promise the greatest return on investment. In his paper *The Link Between Job Satisfaction and Firm Value with Implications for Corporate Social Responsibility*, Alex Edmans argues that firm investments in intangibles, though value-creating over time, are simply not incorporated accurately into current stock prices. He explains, "…intangibles are not incorporated because the market lacks information on their value. Since they cannot be measured, it is hard for managers to credibly certify their value to outsiders." His results thus "support managerial myopia theories in which managers underinvest in intangibles because the market values them only in the very long run. This conclusion in turn has implications for how to design organizations to encourage long-term growth. We currently evaluate managers according to quarterly earnings announcements. But to induce intangible investment, we must pay them based on

[31] Edmans clarifies that "examples [of intangibles] include intellectual property (patents and trademarks}, brand, customer loyalty, and human capital. Previous studies have identified various intangibles that are not fully valued: firms with high R&D as measured by expenditure, advertising as measured by expenditure, patent quality as measured by citations, and software quality as measured by development costs all earn higher long-run returns."

the stock price far into the future."[32] According to Edmans' findings, those firms who invest in intangibles are ultimately more successful, more valuable, in the long run. However, we are discouraging this type of far-sighted investment behavior with our current valuation methodologies. In order to give firms the ability to act as visionaries, then, we must overcome this shortsightedness and begin to quantify long-term value creation financially through reformed practices and incentive schemes.

2e. Summary

Individual and corporate finance, propped up by the actions of underlying financial institutions, has empirically deviated from its theoretical purpose. Though the scale of this deviation today is difficult to gauge, it is nonetheless imperative to begin making incremental improvements in the infrastructure of modern finance to move reality in line with theory. This shift in philosophy and practice will only come with a behavioral adjustment of those individuals and firms operating within the financial industry itself. As Shiller points out, "the essential challenge for leaders to contemplate in coming to terms with the future of finance is to understand that it can be used to help broaden prosperity across an increasingly wide range of social classes, and that its products can be made easier for people to use and can be better integrated into the economy as a whole."[33] If the future of finance is in fact to be a bright one, then financial institutions must begin acting responsibly, understanding their obligation to spread prosperity to the many rather than restricting it to the

---

[32] Edmans 14

[33] Shiller 8

few, and promoting practices and tools that contribute to robust economic growth rather than short-term profit.

Leaders in the financial space, whether they are CEOs of corporations or heads of financial institutions, must reorient the instruments of finance in pursuit of the democratization of wealth going forward. The student loan market must be a means of accessing, not barring education. Corporate entities must utilize financial markets to increase their individual competitiveness rather than bar potential market entrants. Financial institutions must recognize their instrumentality in keeping the capitalist free market system healthy.[34] Only under these admittedly more theoretical circumstances can finance truly serve its fundamental purpose and generate prosperity on a broad social scale.

III. Correcting Finance

Finance can be incrementally improved in order to reconcile empirical observation with the theoretical aims of finance: self-determination, efficient allocation, fairness, and long-term wealth growth. To this end, future innovation in finance must have an embedded sense of social responsibility towards the individuals and corporations for whom finance is allegedly working. Actors within the financial space must take into greater account the social externalities of their actions rather than simply analyzing fiscal implications. Lastly, the orientation of financial institutions must be altered to better align the cooperative aims of these institutions and the actors outside of the financial space that the institutions are intended to serve. As Asli Demeriguc-Kunt and Leora Klapper reinforce:

[34] Rajan and Zingales 45

> "Well-functioning financial systems serve a vital purpose, offering savings, credit, payment, and risk management products to people with a wide range of needs. Inclusive financial systems – allowing broad access to financial services, without price or nonprice barriers to their use – are especially likely to benefit poor people and other disadvantaged groups. Without inclusive financial systems, poor people must rely on their own limited savings to invest in their education or become entrepreneurs – and small enterprises must rely on their limited earnings to pursue promising growth opportunities. This can contribute to persistent income inequality and slower economic growth."[35]

This insight makes clear that the principles of self-determination, efficient allocation, fairness, and long-term wealth generation can actually be pursued under a system of well-functioning markets. Moreover, such well functioning markets, when in place, can serve to close the social inequality gaps that have been created and exacerbated as a product of mismanaged markets. If financial markets are compelled, in practice, to pursue the principles for which they were initially formulated, the result will be greater social equity of wealth and social opportunity going forward. Synthesizing the conceptual and the empirical in finance will become critical to ensuring the trustworthiness of the financial industry in the future and therefore is the key to its sustainability.

3a. Financial Engineering in Pursuit of Self-Determination

Personal financial products must be designed that give individuals the tools they need to turn their present investments into future successes while also allowing them to live a life that they deem meaningful. Through an investment in their own education or in a private home, individuals can increase their own wealth and explore their idiosyncratic passions with the help of finance. Doing so, ideally, will give these individuals the capacity to repay their loans, an outcome that is also

[35] Demirguc-Kunt and Klapper 1

in the best interest of financial institutions. This system of reciprocity, based on honest contracting and trust between individuals and financiers, can be established through properly designed, humanized financial products.

One creative form of financial innovation that can help establish a symbiotic relationship between individuals and finance is insurance. Home insurance, life and health insurance, education insurance, and even more idiosyncratic forms such as crop insurance, can give individuals the peace of mind that they need to pursue their dreams while providing them with financial security in the event that their pursuits do not succeed. Properly devised systems of insurance, in other words, can allow finance to act as an instrument of self-determination through its liberating effect on the individual. In constructing future insurance contracts, as Shiller elaborates, "if the insurance industry is to become more humanized, it has to deal better with the real risks that trouble people…" Shiller goes on to explain that current disability insurance, while hedging some of the risk associated with individual disabilities, does not fully cover all the risks to their livelihoods. He claims, "in the future, insurance can and will do much more." Accordingly, Shiller suggests that we adopt an innovative new approach to disability insurance called livelihood insurance. He explains:

> "This would be a long-term insurance policy that an individual could purchase on a career, an education, or a particular investment in human capital. One could choose to specialize far more narrowly than is commonly done today – say, on a particularly interesting career direction – developing the expertise for such a career without fear of the consequences if the initiative turned out badly. The insurance policy would pay off with a supplement to one's lifetime income if it turned out years or decades later,

> based on verifiable data, that there was less of a market, or even no market at all, for people with this career."[36]

Livelihood insurance represents a product of financial engineering that puts the human at the center of its design. It encourages individuals to be self-determinant, it indulges in idiosyncratic passion, and it provides necessary financial security if the individual's pursuit is not successful. Future products, similarly, should seek to act as instruments of self-determination to bring empirical finance in line with conceptual ideals.

3b. Enlightened Value Maximization as a Solution to Allocative Inefficiency

Finance can enhance its allocative efficiency by identifying and funding business opportunities that generate maximal long-run social value, rather than continually catering to the entrenched interests of corporations that dominate capital markets. One way of doing so, proposed by Michael Jensen of the Harvard Business School, is to use "enlightened value maximization" as a tool of fundamental analysis. Rather than determining the intrinsic value of a company through strictly financial multiples such as price-to-earnings or price-to book ratios, Jensen's enlightened value maximization ascribes added value to firms whose operations and management are optimizing long-term market value. His valuation methodology, while not fully ignorant of short-run profit indicators, "adds the simple specification that the objective function – the overriding goal – of the firm is to maximize total long-term firm market value. In short, the change in the total long-term market value of the firm is the scorecard by which success is measured." This approach addresses short-term allocative inefficiency because it "recognizes the possibility

[36] Shiller 67

that financial markets, although forward looking, may not understand the full implications of a company's policies until they begin to show up in cash flows over time…"[37] By helping to identify investments that will be sustainably successful, this form of valuation gives financial companies the ability to operate in a more forward looking manner. It can help them overcome a short-term bias towards simply investing in companies with which they are familiar in favor of investing in companies with more long-term growth and future value potential. Financial institutions electing to use enlightened value maximization as their preferred method of fundamental analysis can have the effect of compelling managers and directors to act in what they believe to be the best long-run interest of the firm. While not a complete solution to the problem of short-termism, it analyzes performance based on overall value-added and long-term wealth creation, not simply instantaneous profit metrics. This strategy of fundamental analysis can thus help refocus managers and directors of firms and can help financial institutions allocate capital into the proper channels to broaden the scope of economic growth.

3c. Reinstating Fair Distribution of Wealth

Finance must stop contributing to the unfair allocation of monetary and capital resources. Disproportionate wealth accumulation at the top of the economic pyramid can be addressed through a variety of strategies, including government regulation of financial institutions and asset-based redistribution schemes. One area in which government can realistically intervene is in regulating the generational transfer of resources to members of the same socioeconomic class. Inheritance caps

[37] Jensen 17

can limit the amount of wealth that is transferred from generation to generation, helping to narrow opportunity gaps that entrench social positions. Rajan and Zingales acknowledge, "inefficient and concentrated control of wealth does impose all kinds of costs on society. That is why an inheritance tax, structured so that the rich are encouraged to transfer passive ownership of productive assets, rather than active control, to their children would make sense…[The tax's] aim should be to achieve the efficient distribution of control."[38] This regulation, far from removing individual incentive to work for profits in one's own lifetime, has the implicit effect of equalizing economic market access for all individuals over time. Equal market access, in turn, can help finance achieve the purpose of satisfying claims in proportion to their standalone strength rather than satisfying them as a function of an unfairly inherited legacy of wealth. In this same vein, the government can also mandate that financial institutions make their resources, such as commercial banking services, financial advisors, and credible lending institutions, available at proportionally compatable prices to underserved communities so that the poor can take advantage of these resources to the same extent that the rich are able to. Breaking down the barriers to market access for all members of society will usher finance in the direction of fairness, allowing competitive ideas to stand on their own merits without regard to prior socioeconomic positioning.

Even more far-reaching strategies, such as the one proposed by Louis Kelso, a former corporate lawyer and investment banker, can be implemented that help implicitly redirect capital in a more "fair" manner through financial markets. Kelso,

---

[38] Rajan and Zingales 299

drawing on the earlier influences of Nobel Prize winning economist James Meade and Yale economist John Roemer, "realized from his professional experience that one of the main – and strikingly obvious – reasons his rich clients were able to multiply their ownership of stocks and bonds was that their existing wealth provided them with collateral that allowed them to borrow money for further investment…If the poor had access to collateral and experts, Kelso reasoned, why could they not also make money by investing borrowed funds?"[39] Accordingly, Kelso proposed the creation of a "Capital Diffusion Insurance Corporation," which would allow the government to insure individually purchased portfolios of diversified products. These portfolios would be sold principally to those without significant previous exposure or access to such financial products. The government in this scheme would hedge its investment risk by mandating that portfolios remain in escrow until paid off by dividends, at which point the portfolios would fall under full ownership of the individual, giving them a second source of income. This scheme would "ultimately result in a major system-changing buildup of wealth among the citizenry" with an added perk being that it "does not propose taxing away or expropriating existing wealth. Instead, a steady shift in ownership would be slowly accomplished as *new* wealth is created in the normal processes of economic development over long stretches of time." This type of structural reform, extending credit fairly and thoughtfully to those in underserved communities, will increase financial literacy and sophistication in these areas. Over time, capital ownership will

---

[39]Alperovitz 25

be implicitly democratized, opportunity gaps will be narrowed, and finance will structurally be directed towards serving its purpose of fair wealth distribution.

3d. Long–Termism and the Socially Responsible Investing (SRI) Movement

Progress has been made in the field of financial innovation to develop instruments that intrinsically embed some form of long-term social purpose or responsibility. "Impact investing," whereby capital is contributed to socially responsible investment vehicles with environmental, social, or governance (ESG) criteria embedded into their core philosophies, has expanded in the U.S. from a $639 billion industry in 1995 to a $3.74 trillion industry in 2012, with 11% of all professionally managed assets falling into a "socially responsible investments" portfolio.[40] The expansion of this asset class, a result of SRI's comparable return profile to traditionally diversified portfolios, represents a growing demand for financial products to reflect more conscientious, growth-oriented investment strategies.[41] The deepening of the SRI field in recent years, as a Rockefeller Institute Report entitled *Achievements, Challenges, and What's Next in Building the Impact Investing Industry* explains, comes as a result of "growing recognition that existing resources are insufficient to address severe poverty, inequality, environmental destruction, and other complex, global issues, especially among Western nations

---

[40] Fung 51

[41] SRI negative screens focus on removing traditionally socially "irresponsible" companies from their investment universe. Examples of such companies can include those that contribute to environmental pollution or have weak corporate governance structures in place. SRI positive screens, alternatively, will source companies whose operations can contribute to long-term value creation through human capital investment in employees or capital allocation to research and development.

that are already reducing their aid budgets and domestic social spending."[42] Accordingly, large pools of capital overseen by financial institutions are beginning to adopt a stronger social position, intending to compensate for the immediate shortfall they recognize as having been created within and among modern state institutions. These funds' social position must necessarily be supported by a long-term, value creation objective rather than short-term profit maximization. The recent growth of the SRI field implies that such value creation can in fact become the mainstream as the SRI market matures, allowing finance to more organically serve its goal of long-termism.

The Canadian Pension Plan Investment Board (CPPIB), with $170.1 billion in pension funds under its management, is an example of a financial institution that has taken a long-term, socially considerate approach to its own investment activities, believing that it can produce stronger long-term fund performance with a conscious investment philosophy. As CPPIB's "Policy on Responsible Investing" platform affirms, "responsible corporate behaviour with respect to environmental, social, and governance factors can generally have a positive influence on long-term financial performance."[43] In accordance with this investment philosophy, CPPIB uses its financial power to help develop spaces like the green tech industry, or to support companies with more intangible value in the form of progressive management or board structures. In this scenario, tools of finance are being used to bolster the infrastructure of the "good society," creating positive mutual payoffs for both investors and for society more broadly. The CPPIB's philosophy has, to date,

---

[42] Rockefeller x
[43] CPPIB Policy on Responsible Investing 3

been enormously successful in growing the size of the national pension fund and, all the while, has been instrumental in driving forward numerous development and sustainability initiatives across the world. Financial innovations should, accordingly, embed concepts of social responsibility and adopt an investment angle that ascribes greater value to intangibles if they seek to be profitable over a long-term time horizon.

To continue advancing a culture of moral obligation in finance, it must be acknowledged that profitability within markets and social progress are not mutually exclusive. Financial institutions cannot be profitable if they refuse to propagate a vibrant economic system. Neglecting this social responsibility in turn harms those who depend on stable, dependable economic growth to realize their goals in life and in business. Rajan and Zingales reiterate regarding this symbiotic relationship:

> "No one will have the incentive to undertake long-term investment – whether in acquiring specialized skills or in building physical capital – when there is no clarity about what the rules of the game are. Thus, the societal pie shrinks, and more and more of what remains goes to the ruling clique because they have the arbitrary power to determine shares…The right answer is not to concentrate economic power even more but to disperse it more widely. And one way to do this is to expand access to finance."[44]

Thus if finance seeks to be sustainable and trustworthy in the future, as it should given the countless benefits that healthy markets can provide, it must jointly incentivize cooperative action on the part of both entities in a financial transaction. Institutions must be assured that they can collect on loans or investments that they make, which they can gain greater assurance of through lending and investing responsibly. Long-term objectives must take precedent over a short-term financial

[44] Rajan and Zingales 45

prisoners dilemma for this type of financial infrastructure to take root. Should this objective be achieved, though, the social and financial payoffs to all actors involved can be increased.

IV. The Future of Wealth Democratization

1. What is Wealth Democratization and should it Constitute a Social End?

Wealth democratization is the process through which inequality is diminished with broadened access to society's assets. The focus of wealth democratization should be the subset of society with restricted access to these assets, typically those on the lower end of the socioeconomic spectrum. Assets can be material and can include money, shelter, or leisure items; or they can be of a more intangible nature, and can include availability of high quality education, access to reliable public safety outlets, or even a feeling of security in one's own community. All of these assets are critical to the production of a robustly "wealthy" society and, thus, we should seek to maximize each individual within society's access to these assets if we want to construct a more solid social foundation.

Wealth democratization, because of its multi-dimensionality, must be a proactive process, brought about by the restructuring of institutions that direct and control social wealth. Wealth democratization cannot be achieved through retroactive redistributive measures or through progressive taxation schemes. Rather, it must be driven forward by broader economic growth, a byproduct of the proper functioning of financial markets. In this regard, the orientation of financial institutions is most critical. Financial institutions, through their products and practices, have a unique ability to spread or restrict access to scarce social assets. As

Rajan and Zingales note, "a good financial system broadens access to funds. By contrast, in an underdeveloped financial system, access is limited. Because funds are so important, the financier who controls access is powerful, but because access is so limited, the financier can make money doing very little."[45] Within this example, the modern US financial markets have come to resemble an underdeveloped, or improperly functioning, financial domain. Financiers with control of funds, who have the power and discretion to broaden access to opportunities such as education and home ownership, have neglected to use this position of power to service the best interests of society. Rather, by raising premiums on student loans or selling toxic securities to trusting investors, financiers have often managed to garner wealth for themselves and their firms at the expense of a greater social goal. To the extent that a socioeconomic obligation begets finance, institutions must thus be reoriented in pursuit of greater wealth democratization.

The pursuit of greater democratization of wealth through expanded access to value-creating financial tools should constitute a social end. By spreading wealth more equitably, the tools of finance have the power to raise the bottom line in society and contribute to a regenerative cycle of economic productivity. In formulating the concept of a "pluralist commonwealth" in *America Beyond Capitalism*, Gar Alperovitz seeks to imagine a society in which economic and financial innovation is only embraced if its core purpose is to provide for those with limited access to capital more efficiently or effectively than existing infrastructure is able to. The essence of the pluralist commonwealth lies in "the principle that

[45] Rajan and Zingales 27

ownership of the nation's wealth must ultimately be shifted, institutionally, to benefit the vast majority."[46] Redistributing wealth institutionally rather than retroactively, Alperovitz argues, stimulates the economy from the bottom up. It allows those previously excluded from the world of finance to enjoy its intrinsic benefits and, thus, contribute back positively to the overall economy. A financially inclusive infrastructure, Rajan and Zingales agree, allows society to unlock otherwise latent sources of economic growth, which can create a positive feedback of economic and even social stability. Though more equitable financial inclusion does not imply, on one dimension, that income inequality will be narrowed, it does create the possibility that those at the base of the socioeconomic pyramid can enhance their probability of achieving financial success. Accordingly, they note that in theory, "financial revolution is thoroughly liberal in spirit. Instead of capital, it puts the human being at the center of economic activity because, when capital is freely available, it is skills, ideas, hard work, and inescapably, luck that create wealth."[47] Thus wealth democratization can underlie a social revolution to replace the unfairly biased socioeconomic status quo with a more economically constructive ordering. In reorienting finance to be more wholly inclusive, then, we can also hope to achieve greater economic stability and long-term growth.

2. Historical Alternative Means of Democratizing Growth

Historically the systematic redistribution of capital through retroactive tax measures or a graduated income tax has served as the primary means of democratizing "wealth" socially. However, such measures are simply insufficient to

[46] Alperovitz 79
[47] Rajan and Zingales 92

promote greater sustainable social equality through wealth democratization. Progressive taxation, for example, does not provide people with the same incentives to contribute back to the economy as does supplying them with empowering financial tools because it is an "after-the-fact" measure. It has little to no bearing on actors' prior behavior. Further, the opportunity costs of such redistributive measures are significant: we are economically disincentivizing those with lower incomes to mobilize their powerful human capital resources, and we are incentivizing those with higher incomes to seek short term individual profits that outpace the tax schemes. Still, this form of redistribution has been pervasive because of its political defensibility and because of the ease with which it can be systematized. It is clear today, however, that "redistributive 'after-the-fact' measures are no longer viable, and something much more fundamental is needed" to adequately address growing wealth inequality trends.[48]

In deriving alternatives to 'after-the-fact' taxation measures, new methods of redistribution have been proposed that attempt, but have not yet succeeded, to systematically democratize wealth. Measures such as the Earned Income Tax Credit and more proactive federal tax subsidies for asset ownership seek to generate economic activity among those on the lower end of the socioeconomic spectrum. It is the goal of such measures to subsequently allow these members of society to contribute to a more robust and stable economic growth, with payoffs for this growth being realized widely and more sustainably through a positive feedback

---

[48] Alperovitz 19

mechanism.[49] These taxation schemes encourage saving rather than punishing consumption, and can provide broader access to physical assets that can, allegedly, be put to more productive use when in the hands of a broader subset of society. Nonetheless, they are still far from ideal in allocating society's resources, as they must presuppose inequality. As Richard Freeman, a Harvard economist and author of the book *The New Inequality: Creating Solutions for Poor America*, remarks idealistically, "if we were to start democratic capitalism with a blank slate, we would naturally divide the ownership of existing physical assets equally among the population… Our main strategy – be we left or right – for fighting income inequality under capitalism, should be to assure a fair initial distribution of physical and human capital themselves…equality of income obtained in the first instance via greater equality in those assets, rather than as after-the-fact (of earning or luck) state redistribution of income from rich to poor, would enable us to better square the circle of market efficiency and egalitarian aspiration."[50] Though this depiction of a more egalitarian capitalist society is indeed a romantic one, it is simply incomprehensible that we could revert today to a social blank slate and begin dividing assets equitably. For this reason, those with substantial control of society's assets, namely financiers and financial institutions, should be forced to adopt a systematic bias in favor of provisioning assets more fairly. If financial institutions can accomplish this goal, inequality could begin to recede as a social presupposition as the stratification of society began to narrow. The tighter association of social classes has several positive implications for future economic creativity, growth, and

---

[49] Alperovitz 202
[50] Freeman 14

sustainability, and thus must be pursued as an end in itself principally through the reorientation of finance.

3. Finance as the Preferable Means of Democratization

Given that measures such as ‘after-the-fact’ taxation and federal subsidies are insufficient to address the issue of wealth disparities in the U.S., the role of finance in abetting this problem is worth examining. Finance’s implicit instrumentality in directing social capital should allow the proper focus of its faculties to play a substantial role in narrowing ever-expanding wealth gaps.[51] One non-profit instrument of finance, the Community Development Financial Institution (CDFI), serves to illustrate how properly oriented financial infrastructure can play a role in preemptively redistributing capital for the purpose of wealth democratization. CDFIs, which can come in the form of credit unions, banks, loan funds, and venture capital funds, all seek to utilize the tools of finance to broaden initial ownership of assets in traditionally underserved communities. In doing so, these financial institutions take a long-term view of economic development while simultaneously satisfying a responsibility to raise the socioeconomic bottom line. As Alperovitz remarks, “the more than thirty-five year developmental trend that has produced the modern Community Development Corporation is intimately related to the U.S. political economy’s declining capacity to address problems of inequality and

[51] OECD statistics reveal that the US Gini coefficient has been steadily on the rise since data collection began in the mid-1970’s. Though this trend towards greater income inequality has been somewhat muted by the impact of taxes and transfers, the coefficient has nonetheless been positively sloped even when taking these federal measures into account (OECD Stat – Income Inequality)

poverty directly through redistribution or through major job-creation strategies."[52] The CDFI, in contrast with traditional redistribution methods, is preventative rather than responsive in its approach. It provides traditionally underserved communities with greater initial access to assets through the tools of finance, where asset ownership can be leveraged more efficiently and financial investment can be more tangibly converted into broad-based economic growth. In tapping these communities locally, provided that they use the proper tools and procedures, financial institutions can thus align their day-to-day operations with a more conceptual ideal of finance. In this way, rather than through outdated tax schemes that simply address fiscal disparities, we can truly begin the long process of wealth democratization.

Financial tools do not necessarily have to operate in the non-profit sphere to have the effect of democratizing wealth. As Waheed Hussain notes in his critique of Alperovitz's *Pluralist Commonwealth*, competitive financial institutions have no immediate incentive to voluntarily forgo profits for the sake of more evenhanded wealth distribution:

> "For a purely voluntary process [of wealth democratization] to work…you would have to appeal to the public-spiritedness of those who currently own the wealth in society – corporations, private equity funds, large investors, and so on – to donate money to nonprofits, community development organizations, employee stock plans, and all of the rest. Moreover, you would have to get them to donate in amounts that would not only support the livelihood of small groups of people, but would add up to a fundamental shift in the pattern of wealth ownership in society. A voluntary wealth transfer on this scale is not only unlikely, but it would probably be historically unprecedented…"[53]

---

[52] Alperovitz 101
[53] Hussain 39

Given that competitive profit incentives in the private sphere often preclude a natural shift in the direction of wealth democratization, innovative solutions should be designed that can simultaneously satisfy this obligation of finance while producing competitive returns. In this space, Baker and Fung highlight recent financial developments from the private sector that have sought, proactively, to reverse an inclination towards wealth inequity. Specifically, they note the recent ascendance of institutional investors to a position of greater prominence in the responsible investment space. These for-profit investors, which include "insurance funds, public and private pension funds, banks, and mutual funds," are beginning to take a more long-term approach to investing, deemphasizing immediate profit maximization and investing instead in more broadly constructive ventures such as microfinance and infrastructure development that will deliver proven, stable returns farther down the road.[54]

The Omidyar-Tufts Microfinance Fund (OTMF) is an example of a for-profit endowment fund investing in microfinance that seeks a 9% annual return on investment, synthesizing the goals of profitability and wealth democratization. The objectives of this "patient capital" fund, to develop microfinance into a stronger asset class and to open opportunities for business development to traditionally underserved communities, contribute directly to the process of wealth democratization. However, they achieve these objectives while delivering necessary funds to the University for operations and financial aid purposes. As Tufts endowment officer Tryfan Evans even noted, "of the two goals [microfinance

[54] Fung 21

support and a high return on investment], the commercial objective of enhancing the university's return overrides. This flows from the belief that the goal of enhancing capital flows to microfinance in a meaningful way can only be achieved if we first succeed in demonstrating that a commercial investor can achieve commercial objectives such as supporting the operating budget of an educational institution by investing in the sector."[55] As Evans reiterates here, wealth democratization can be compatible with competitive profitability if pursued through appropriately constructed and oriented investment vehicles. If wealth democratization is to remain a fundamental pursuit of the private financial space, as it should be, further innovations such as the OTMF must be designed and implemented to synchronize the goals of profitability and social responsibility.

Finance certainly has the capacity to ensure that wealth is distributed equitably in society. A more wealthy society is one in which people can feel relatively free to pursue their individual goals and interests, and one in which corporations of different sizes and in different stages can feel empowered to compete in a fair marketplace. Certainly wealth can only be generated against a backdrop of economic growth, so financial institutions should only expect to profit fractionally off of the contribution that they make to such economic growth as measured by increases in national GDP. However, should the infrastructure be put in place for finance to spread ownership of society's assets, long-term sustainability can realistically be ingrained into financial transactions with the ultimate payoffs being shared collectively.

[55] OTMF 9

V. Conclusion

Finance is a human institution. Like all human designs, it is imperfect and improvable. Finance conceptually should give individuals a vehicle for self-determination, should fairly and efficiently allocate capital to the individual and the corporation, and should take a long-term growth perspective. As Robert Shiller agrees, "the key to achieving our goals and enhancing human values is to maintain and continually improve a democratic financial system that takes account of the diversity of human motives and drives. We need a system that allows people to make complex and incentivizing deals to further their goals... It must be a system that redirects the inevitable human conflicts into a manageable arena, an arena that is both peaceful and constructive."[56] This simple depiction of finance as an means of translating individual creative expression into broad-based economic growth necessarily engenders a complex system of institutions and products designed to service these lofty goals. Committing financial institutions and practices to the achievement of more democratic prosperity, however, is necessary if we want our financial industry to be a truly sustainable one.

Modern finance has strayed from its obligation to serve the goals of self-determination, efficient capital allocation, fairness, and long-term growth. Deviations occur at both the individual level and firm level and are largely a result of flawed institutional design. Individuals in society who inherit a legacy of wealth are able to more rapidly multiply their resources through the tools of finance, through stocks and bonds and asset appreciation, enjoying greater opportunities to pursue

---

[56] Shiller 237

self-determination than those individuals who constitute the base of the economic pyramid. Financial institutions should work to implicitly remedy, rather than exacerbate, this wealth discrimination over time. Shiller reiterates:

> The democratization of finance…calls for an improvement in the nature and extent of participation in the financial system, including awareness of fundamental information about the workings of the system. The public needs to have reliable information, and that can only be provided by advisers, legal representatives, and educators who see their roles as one of promoting enlightened stewardship. When people can benefit from such help, they will come to feel less strongly that our economy is run by a power elite. At present most people have little or no such information. Instead they are routinely confronted by salespeople for financial products, who have inadequate incentive to tell them what they really need to know. But it could be different under a truly enlightened system of financial capitalism.[57]

Indeed, under a truly enlightened system of financial capitalism, equitable distribution of financial resources can contribute to widened social prosperity and, ultimately, longer-range economic growth. It is imperative that we create a financially inclusive society in order for all individuals to take advantage of finance as an instrument of self-determination and for all emergent business enterprises to have an equal chance to secure investment capital. Through leveling the competitive playing field, we can make finance work for the many rather than the few and generate social wealth in the process.

The wealth generated by a properly functioning financial system should be democratically distributed to ensure sustainability of the system. Past methods of redistribution have failed to address growing wealth gaps because they have focused on income disparity, though income only represents a single component of one's overall wealth. As incomes diverge, so too do opportunities to access high-

[57] Shiller 236

quality education, to purchase appreciable assets, and to receive the credit necessary to advance oneself socioeconomically. Wealth must be democratically distributed through the implicit functioning of financial institutions. The rising popularity of Community Development Financial Institutions (CDFIs) as an alternative to traditional bank lenders, as well as the recent ascendance of institutional investors, have proven that financially inclusive strategies can promote broader, more stable prosperity. Indeed, in the wake of the recent financial crisis, given that these democratically oriented institutions and strategies fared well compared to traditional financial institutions, these models may provide us with insight into how we can best navigate the future of finance.

The institutions of finance can work for all. Through proper institutional orientation, we can maintain a vibrant, competitive, and growing market economy while still raising the bottom line. In concluding his book *Finance and the Good Society*, Robert Shiller notes, "many of our hopes for the future should be pinned on further development of the institutions representing financial capitalism. We are easily dazzled today by advances in information technology, and these advances can certainly interact positively with financial innovations. But the advances in our economic institutions may ultimately be more important than those in our hardware and software. The financial system is itself an information-processing system – one built out of human, rather than electronic, units – and the field of artificial intelligence is nowhere close to replacing human intelligence."[58] Indeed, no algorithm or technological innovation will be able to solve such a fundamentally

[58] Shiller 238

human problem as the orientation of our financial institutions. We must take the reins and steer our finance in the direction of value creation and fair allocation if we hope to envision a socioeconomic future that is both prosperous and sustainable.

Works Cited

Alperovitz, Gar. *America Beyond Capitalism: Reclaiming Our Wealth, Our Liberty, and Our Democracy*. Hoboken: John Wiley & Sons, 2005. Print.

Boatright, John R. "Ethics in Finance." *Finance Ethics*. Hoboken: John Wiley & Sons, 2010. 3-21. Print.

Canadian Pension Plan Investment Board. *Policy on Responsible Investing*. N.p.: Canandian Pension Plan Investment Board, n.d. *CPP Investment Board*. 10 Aug. 2010. Web. 30 Jan. 2013.

Cherry, Miriam A., and Judd F. Sneirson. "Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster." *Tulane Law Review* 85.4 (2011): 983-1038. *Tulane Law Review*. Web. 26 Feb. 2013. <http://www.tulanelawreview.org/beyond-profit-rethinking-corporate-social-responsibility-and-greenwashing-after-the-bp-oil-disaster/>.

Demirguc-Kunt, Asli, and Leora Klapper. "Measuring Financial Inclusion: The Global Findex Database." *Policy Research Working Papers* (2012): 1-58. *The World Bank Development Research Group: Finance and Private Sector Development Team*. Web.

Edmans, Alex. "The Link Between Job Satisfaction and Firm Value with Implications for Corporate Social Responsibility." *Academy of Management Perspectives* 26.4 (2012): 1-19. *Wharton Finance Department*. Web. 12 Dec. 2012. <http://finance.wharton.upenn.edu/~aedmans/RoweAMP.pdf>.

Freeman, Richard. *The New Inequality: Creating Solutions for Poor America*. Boston: Beacon, 1999. Print.

Fung, Archon, Tessa Hebb, and Joel Rogers. *Working Capital: The Power of Labor's Pensions*. Ithaca: Cornell UP, 2001. Print.

Geczy, Christopher C. "Socially Responsible Investing." Impact Investing. The Wharton School, Philadelphia. 5 Feb. 2013. Lecture.

Heath, Eugene. "Fairness in Financial Markets." *Finance Ethics*. Hoboken: John Wiley & Sons, n.d. 163-78. Print.

Hussain, Waheed. "The Limits of a Pluralist Commonwealth." *The Good Society* 15.3 (2006): 37-44. Print.

Jackson, E.T., comp. *Achievements, Challenges, and What's Next in the Impact Investing Industry*. Rep. New York: Rockefeller Foundation, 2012. Print.

Jensen, Michael C. "Value Maximization, Stakeholder Theory, and the Corporate Objective Function." *Negotiation, Organization, and Markets Unit: Harvard Business School* (2001): 1-17. Web. <http://papers.ssrn.com/abstract=220671>.

Orsagh, Matthew. "Visionary Board Leadership: Stewardship for the Long Term." *CFA Institute*. N.p., June 2012. Web.

Rajan, Raghuram G., and Luigi Zingales. *Saving Capitalism from the Capitalists*. New York: Crown Business, 2003. Print.

Reinhardt, Forest L., and Robert N. Stavins. "Corporate Social Responsibility, Business Strategy, and the Environment." *Oxford Review of Economic Policy* 26.2 (2010): 164-81. *Oxford Review of Economic Policy*. Web. 31 Mar. 2013. <http://oxrep.oxfordjournals.org/content/26/2/117.full.pdf+html>.

Roosevelt, Franklin D. "Fireside Chat." Address. Fireside Chat. Washington, D.C. 30 Sept. 1934. *The American Presidency Project*. Web. 2 Apr. 2013.

<http://www.presidency.ucsb.edu/ws/index.php?pid=14759>.

Santo, Gary F., and Lauris G.L. Rall. "Private Student Loan Challenges in an Era of Needs and Challenges." *Journal of Structured Finance* (2010): 106-17. *Institutional Investor Journals*. Web. 30 Jan. 2013. <http://www.iijournals.com>.

Shiller, Robert J. *Finance and the Good Society*. Princeton: Princeton UP, 2012. Print.