Dealing with Financialization - Lessons from Ancient and Modern Societies

by Hendrik Van den Berg*

Abstract

Human societies have over thousands of years developed many practical ways to carry out inter-temporal and inter-generational, i.e., financial, transactions. What many economists now call *financialization* is, therefore, not only a recent phenomenon. What is different today, however, is the sheer volume of inter-temporal exchanges and the particular ways in which societies carry out financial exchanges. Traditional inter-temporal obligations were carried out under a broad set of social arrangements and institutions, but today a much greater share of finance involves new financial instruments and institutions that make the exchanges private and individualistic. We refer to these two aspects of financialization is *financial expansion* and *financial privatization and individualization*, respectively. After examining the role of collective social action in dealing with inter-temporal exchanges in both ancient and modern societies, it is clear that there are still very important roles for collective/government actions. The privatization and individualization of finance has many adverse consequences, such as forcing businesses to focus more narrowly on the interests of major stockholders to the detriment of other stakeholders, enabling the capture of the political process by increasingly wealthy financial and allied corporate interests, and concentrating income and wealth in general. Also of concern is the growing frequency, and severity, of financial crises. And, despite years of financial innovation in the private financial sector, the large and costly financial sectors of the most developed economies still have trouble dealing with informational asymmetries, moral hazard, adverse selection, fraud, risk, and the general uncertainty of human existence. The paper concludes by advocating for more social arrangements and government programs for making societies' necessary inter-temporal exchanges and less reliance on the privatization of finance. The field of economics needs to change its culture in order to eliminate the biases that push its methods and practices towards effectively supporting the privatization and individualization of finance.

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Conventional economic theory has played an important role in promoting financialization.
Thomas Palley, 2007

1. Introduction

Human societies have over many thousands of years developed many practical ways to carry out inter-temporal transactions. People have often incurred debts, while others willingly provided the credit. Societies developed rather complex arrangements for inter-generational exchanges that allowed humans to raise children, care for their elders, and assist the unfortunate. Humans have thus engaged in what we today call *finance* for thousands of years. It is thus equally true that what many writers now call *financialization* is not, fundamentally, a recent phenomenon either. What is different today, however, is the sheer volume of inter-temporal and inter-generational exchanges and the particular ways in which societies carry out those exchanges. Some writers, including this author, view these changes with great concern. Where traditionally inter-temporal obligations were enabled by a broad set of social arrangements and institutions, today a much greater share of finance involves new financial instruments and institutions that make the exchanges more individualistic and personal.

This paper clarifies these issues and attempts to sharpen the arguments for curbing the so-called financialization of our economies. We begin with some definitional refinements.

Defining finance

The term *finance* has several meanings in the economics literature. For example, finance may refer to the conduct or transaction of money matters generally. In everyday language, *financial* is an adjective that refers to anything having to do with money. Sometimes finance refers to the provision of the means of payment for something. Most often, the term *finance* is used to describe inter-temporal exchanges that create some types of debt and credit, as when someone lends money to, or finances, someone else.

Finance is closely identified with money. The reason money serves the role of unit of account and medium of exchange is that it is also a store of value. Money must always reflect some form of future payment, or debt, if people can be induced to hold it on place of real goods and services. Furthermore, there is no money without debt, and every debt is matched by a credit.[1] Looked at another way, the creation of debt creates something that could function as money, namely that there is some store of value that, when the debt is collected, can be used to exchange for real things. Debt is thus effectively a medium of (intertemporal) exchange.

Graeber (2011) explains why money is, necessarily, as old as debt. Since there is anthropological evidence of the use of money at least 5,000 years ago, debt must have been a common phenomenon for at least that long. Humans have thus engaged in finance for as long as there have been debts (obligations) and agreed-to ways of servicing (redeeming) those debts to complete the arrangements (exchange inter-temporally).

Historical examples of finance

What Palley (2007), Epstein (2001), and others have called *financialization* is thus also a much older phenomenon than they let on. Just as Graeber (2011) described how humans found many

[1]Note, however, that finance is not equivalent to economic activity, even though the popular press usually puts stories dealing with economics on the "financial pages," and the ups and downs of the stock market are often taken as indicators of economic conditions. In fact, economic activity covers all human activities related to provisioning, while finance refers only to inter-temporal exchanges that explicitly or implicitly imply various forms of debt (obligations) and credit (future returns).

socially acceptable ways to deal with debt, it is equally true that societies continually developed increasingly complex ways to structure inter-temporal and inter-generational transactions. Thousands of years ago, long before gold coins were stamped or paper money was printed, human societies effectively *financed* current purchases in exchange for future obligations, and they did so under the highly uncertain circumstances that small communities of people lived in 5,000 years ago and earlier. These societies were able to provide implicit forms of debt, insurance, forgiveness, readjustment, monitoring against moral hazard, collateral, enforcement, regulation, etc., all the aspects of finance that modern economies are today struggling to provide for today's large and very complex societies. Historically, intertemporal obligations were usually enabled by social arrangements and social institutions, not the explicit financial and economic institutions that increasingly shape inter-temporal exchanges today.

For example, hunters and gatherers did not have credit default swaps, but their societies provided forms of insurance, such as seeing to it that no member suffered disproportionately in the case of personal misfortune. There were no explicit loan contracts with pages of small print, but there was often a fairly clear understanding of everyone's obligations and privileges across generations, sexes, and individuals. There was no social security system, but early human societies most certainly had implicit, but well-understood, pay-as-you-go systems in which able bodied working-age members of society provided various types of care for younger and older generations. Parents raised children and, if necessary, supported their older parents; children grew up to raise their own children, while in turn also assisting their older parents. Depending on the culture, often many members of a community participated in the education of children.

What these examples make clear is that inter-temporal obligations can be created and managed by means of social relationships, rules, norms, hierarchies, and institutions. That is, finance is not a modern phenomenon that was created only in the past few centuries, as stories about the development of modern banking and financial instruments would have us believe. This is not to say that the new economic institutions and instruments, like modern banks, stock exchanges, bond markets, insurance contracts, and credit default swaps, are not recent developments. In fact, the shift of intertemporal obligations and redemption mechanisms from informal social arrangements or collective governance arrangements to more precisely defined financial instruments, transacted on financial markets and supported by formal legal and political institutions, is indeed a new phenomenon. But these are new developments in a very traditional category of human economic activity, namely inter-temporal exchange or what we call finance.

This paper examines the evolution of financial transactions in our economies from a historical perspective. Such a historical perspective permits us to better understand why modern finance and certain changes in how finance is carried out, often referred to as *financialization*, are indeed issues that demand concern. Specifically, this paper argues that a major factor in how we have shaped inter-temporal and inter-generational exchanges today has been the shift from collective action through government and other social arrangements towards the privatization and individualization of inter-temporal financial arrangements. Accompanying this privatization of finance has been the increased privatization and individualization of the ownership of assets under the completely unsubstantiated hypothesis that private ownership generally leads to more efficient economic outcomes. To make our case, we examine the role of collective action to deal with inter-temporal exchanges in both ancient and modern societies.

Some economists have referred to this privatization and individualization of inter-temporal and inter-generational obligations as *financialization*. However, to understand this phenomenon, we need to sharpen the definition of financialization.

2. Defining Financialization

Some economists have defined the growth of the private financial sector of an economy that concerns itself with arranging, managing, and completing financial transactions, as *financialization*. Others have focused on the growth of financial exchanges in general as financialization. Epstein (2001, p. 1) argues that financialization is the growth of private financial activity:

> Financialization refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the national and international level."

We argue that these alternative definitions of what various authors have called *financialization* are confusing because they mix two separate phenomena, growth if finance and privatization of finance. Some definitions refer to an increase in the amount of debt and other forms of inter-temporal and inter-generational obligations relative to overall economic activity, while the others refer to the shift from traditional social arrangements for dealing with these inter-temporal obligations to the more precise and legalistic formal financial arrangements that include financial markets, specific financial instruments, and modern institutions, such as banks, insurance companies, stock markets, financial laws, and courts to enforce the formal arrangements.

The literature has also often simply taken one definition or another before moving on to analyze the potential consequences of financialization. There indeed are many consequences. For example, Krippner (2005) highlights the increased focus on "shareholder value" as the guiding principle for corporate governance. Palley (2007) points to the rise in economic and political power of the *rentier class*. Krippner also specifically emphasizes the result that profits in the economy are increasingly derived from financial activities as opposed to productive activities. More broadly, from a microeconomic perspective the concentration of profits in the financial sector undermines the management control of corporations engaged in productive activities. And, from a macroeconomic perspective, the concentration of profit in increasingly global financial firms and markets undermines the autonomy of the state and its ability to carry out economic policies that target the interests of groups other than rentiers and the managers of the privatized financial industry.

Palley (2007) points out that the transfer of income from the real sector to the financial sector coincided with globalization, the stagnation of workers' wages throughout most advanced economies, and the reduction in government regulation of finance. He further distinguishes the growing fragility of finance in general, which has led over the past three decades to increasing numbers of financial crises and economic slowdowns.

Note that the more precise definition of financialization is necessary in order to study these various consequences as well as potential policy responses. Is income inequality due to the relative growth of inter-temporal exchanges in general? Or, is the growing inequality specifically due to the growth of the private financial sectors of the world's economies? Much confusion can be eliminated by defining two new terms to cover the two separate aspects of the general phenomenon referred to as *financialization*: (1) the *expansion* of finance and (2) the *privatization and individualization* of finance. The first term refers to the straightforward increase in the value of inter-temporal and inter-generational obligations taken on throughout the economy relative to the total level of economic activity; the second refers to the creation of formal arrangements that precisely establish obligations for individuals and other legal entities as opposed to future social and economic obligations that people, families, communities, and entire nations of people accept as a normal part of collective social behavior. This separation is especially important for thinking about how to deal with the negative effects of the financialization of our economies. The policies needed to reverse the quantity of financial exchanges relative to overall economic activity are usually different from the policies needed to reverse the increasing privatization of such inter-temporal and inter-generational transactions. Also, note that it is quite possible to increase the amount of inter-temporal exchanges relative to total "provisioning" activities while also decreasing the amount of private financial transactions. The two phenomena are conceptually and politically separable.

For example, Palley (2007) writes that financialization (1) enables the financial sector to gain the power to exploit the economy's need to engage in inter-temporal transactions and thus direct income from real activities to financial firms, (2) makes inter-temporal transactions more impersonal and potentially more damaging to some individuals, (3) results in less transparency and thus a less stable financial structure, (4) significantly changes the economic behavior of people and business organizations, and (5) changes how economic policy affects economic outcomes. Note that he effectively focuses not on inter-temporal exchanges per se, but on the *privatization* of finance. This focus leads Palley to see financialization as "a process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes." Clearly, this troubling political consequence of financialization is due to privatization and the rising profits that a private financial industry generates, not the incurrence of inter-temporal obligations per se. An expansion of social security, tax-funded government health insurance, or tax-funded unemployment insurance would not directly increase private profits or necessarily give the financial industry more political clout.

To the extent that the consequences of financialization depend on the degree to which it consists of the mere expansion of inter-temporal exchanges of obligations among groups of people or the privatization/individualization of such inter-temporal exchanges, it becomes necessary to consider how these two categories of financialization can be shaped as an economy evolves. That is, by being more precise about what types of financialization are possible, we can better decide what type of finance is necessary for economic progress.

3. Is Financialization Necessary?

Many mainstream economists argue that modern societies have no option but to make financialization work because wealthier and more complex economies must necessarily arrange for more inter-temporal exchanges. Hicks (1969) famously wrote that the Industrial Revolution would have been impossible without the concurrent development of banking and financial markets. The mainstream economics literature refers to the expansion of formal private finance positively as an increase in the *depth of the financial sector* (Shaw 1973, King and Levine 1993, Levine and Zervos 1996, World Bank 2012), and many economists have argued that the privatization of finance necessarily expands as an economy grows and becomes more complex, and this indeed seems to have happened over the past several decades of capitalist growth. Historical data does not, in general, support the hypothesis that modern privatized and individualized finance has improved human well-being, however.

The replacement of social arrangements for inter-generational and inter-temporal exchanges by the development of money, debt, and modern financial instruments often makes complex inter-temporal financial arrangements more difficult, not less difficult, because privatization has "un-socialised" and individualized inter-temporal and inter-generational exchanges. The use of money and markets in place of social institutions has made formal debt less adjustable to changing circumstances than the more traditional obligations and conventional inter-personal arrangements. Quantification of individual obligations and demands for settlement often causes debt to become exploitative, either by intent in the case of loan sharking and pay-day loans or more generally when economic circumstances change unexpectedly, and it has also made it difficult to incorporate elements of insurance into financial arrangements without introducing additional moral hazard and adverse selection problems that private markets have trouble dealing with. As a result, private financial markets often fail to complete many potentially useful financial transactions, thus leaving many people less well off than they would be under more complete social inter-temporal or inter-generational arrangements.

It is important to recognize that worldwide economic growth was fastest during the decades of the 1950s and 1960s, when in fact the privatization of finance had been severely reduced through regulation in many countries. In the U.S. in particular, the various financial reforms enacted during the 1930s greatly reduced the complexity of private financial exchanges during the two post-World War II decades, yet economic growth and the general rise in living standards was unprecedented by most measures. Philippon (2011, p. 3) examines a variety of data on the extent of financialization and concludes that "finance was smaller in 1980 than in 1925. Given the outstanding real growth over this period, it means that finance size is not simply driven by economic development." Interestingly, Philippon finds that the only thing that has increased is the volume of trading on financial markets, but in a follow-up work (Philippon 2013), he concludes that this growing trade has not improved the performance of financial markets. His conclusions echo the observations of Keynes (1936) in his Chapter 12 of the

General Theory. Assa (2012) provides some support of Philippon and Keynes with an econometric study of the growth of the value added and employment of the financial sectors of OECD countries: he finds that the growth if the financial sector is negatively correlated with economic growth, economy-wide employment, and income equality.

It is, therefore, possible to eliminate some of the negative aspects of the privatization of inter-temporal arrangements without reducing economic growth. In fact, there may be substantial welfare gains from reversing the recent growth of financialization in general and the privatization of finance in particular. It is critical to keep sight of the two components of financialization, however, because the overall growth of economic activity will tend to increase the need for more inter-temporal exchanges of all types. After all, a wealthier society saves more for retirement, has more assets to insure and potential losses to insure against, engages in more investment to maintain and expand its capital stock, and has more need to invest in the education of their children to pass on increasing amounts of knowledge. But the growth of inter-temporal arrangements need not consist entirely, or even predominantly, of privatized arrangements.

The choice between private and social arrangements should be made objectively, which means it should depend on which form of financialization provides the greatest gains in human well-being relative to the social costs such arrangements impose. This is easier said than done, of course, but history suggests societies can indeed expand their social institutions to carry out many of the inter-temporal exchanges and insurance arrangements. There are many examples of alternative arrangements for which the costs can be compared. These examples come from ancient, medieval, and recent history, as well from the present. The overwhelming anti-government bias of the contemporary mainstream economic culture cannot hide the fact that social inter-temporal arrangements very often outperform privatized financial arrangements.

4. Historial Examples of Finance

Humans have engaged in inter-generational and many other inter-temporal exchanges for tens of thousands of years. Economists forget that pre-financial societies mobilized resources for the upbringing of children without a student loan industry, provided elders with dignified living conditions without pension funds, assisted those with misfortune without an insurance industry, and carried out community projects without a bond market. In fact, pre-financial societies made inter-temporal and inter-generational arrangements that were complex mixtures of straight finance, options, insurance, and provisions for dealing with moral hazard, adverse selection, fraud, and exploitation. And, these arrangements and institutions operated successfully under conditions that were highly uncertain, not merely risky.

Medieval Mediterranean trade

Avner Greif (1995) describes how in Medieval Europe merchants developed a system of trust to support the financing of long-distance commerce. Game theory has shown, for example, that the growth of trade among "strangers" over long distances requires a repeated game format, because if the individuals in the "game" do not face repeated contacts, current cheating will not be adequately discouraged by the possibility of retaliation in the future. Indeed, individual merchants in Medieval Europe seldom dealt with each other more than once, and yet they routinely shipped goods to each other under the expectation that payment would be forthcoming.

Greif's examination of historical records uncovered various schemes that resembled collective arrangements under which all borrowers in a community share each others' obligations. For example, Greif uncovered one case of a merchant from Genoa in Northern Italy who was late in making a payment for goods shipped by a trader from Tripoli in Northern Africa. Authorities in Tripoli sent a notice to their counterparts in Genoa, and soon thereafter the Genoese trader sent the payment to Tripoli along with a message explicitly requesting the North African trader to not hold any Genoese for ransom. Apparently, the tardy Genoese trader had come under pressure from other Genoese traders to make the payment because there was an informal system in place whereby merchants from the same city were held responsible for the unpaid debts of their fellow citizens.

Greif found many other instances of community and group responsibility for individual debts. In Greif (1989a), he describes how some merchants organized into peer organizations or networks, within which each member found it to be in his best interest to operate according to established rules that ensured the best outcome for the group. These coalitions of merchants were necessary because “Agency relations in the period under study were characterized by asymmetric information, since the revenues the agent received depended upon circumstances that were not directly observed by the merchant.”[2] Hence, in a perfectly competitive market, where “faceless” buyers, sellers, and firms interact in anonymity, an overseas agent might easily be tempted, in the absence of some other force compelling him to be honest, to misreport the price of the transaction and embezzle some of the revenue. And since everyone knows that an anonymous agent has an incentive to cheat, merchants would be are reluctant to hire such a merchant in the first place. But, how then is a merchant to sell overseas without personally going with his merchandise to the foreign market to ensure payment?

In the absence of a strong legal structure for enforcing contracts, reputation can serve as an enforcement mechanism, provided reputation was important to one’s long-run well-being. This is where the coalition comes in: a network of Jewish traders known as the Maghribi,

[2] Avner Greif (1989), p. 865.

operated under the following implicit rules: (1) each coalition merchant will employ only coalition merchants to serve as their agents abroad, (2) all members agree to immediately stop dealing with any member who is caught cheating another member, and (3) all members will be free to cheat (punish) any member who is caught cheating one of the members. This implicit contract "enables merchants to employ agents for assignments which both parties know ahead of time will be of short duration. Since an agent who considers cheating a specific merchant risks his relations with *all* the coalition members, the agent's lifetime expected utility is rather robust with respect to the length of his associations with a specific merchant."[3] The Maghribi traders successfully bought and sold their goods throughout the Middle East and Mediterranean region despite the lack of legal institutions to enforce formal contractual arrangements.

The essence of this example is that informal institutions such as social networks can substitute for formal institutions. Adam Smith (1776[1976]) in effect anticipated today's literature on networks when he described in his *Wealth of Nations* how the strict social organizations of religious sects provided a behavioral guarantee that could substitute for formal government institutions to enforce contracts. Informal arrangements often enable exchanges where markets do not function well or not at all.

Monte de Piedad and collateral enable low-interest loans

In 1450 in Perugia, Italy, the Franciscan religious order established the Monte de Pietá pawn shops that provided zero interest loans. Loans were given in exchange for collateral deposited physically with the Monte de Pietá (literal translation: deposit of mercy). In place of interest payments, which were illegal under the rules of the Catholic Church at that time, borrowers were strongly encouraged to make a contribution to the church. The institution, therefore, was both a

[3] Avner Greif (1989), p. 878.

source of revenue to the church and a less onerous alternative for desperate lenders who would otherwise be forced to deal with private lenders who often charged exorbitant fees and interest rates. The movement spread throughout Roman Catholic Europe, and in 1774 it arrived in New Spain (Mexico).

Pedro Romero de Terreros, the owner of several colonial enterprises in New Spain, including the Real del Monte silver mine in Hidalgo where thousands of poor workers toiled in near-slave like and extremely dangerous conditions, contributed his ill-earned fortune to the church for founding the Sacro y Real Monte Pio de Animas (The Sacred and Royal Pawn Institution for Souls). Now called the Nacional Monte de Piedad, the institution still functions today, managed from its headquarters on the northwest corner of the Zócalo, the huge central plaza in Mexico City. The institution was set up to (1) make small low-cost loans to people in need of emergency assistance and (2) to use its accumulated profits for funding charitable organizations. A few years after its establishment, its board authorized the charging of interest on loans, a controversial decision at the time. The Monte de Piedad survived Mexico's independence from Spain in the early nineteenth century, when it dropped the "Real" from its name, and the separation of church and state after the Mexican Revolution in the early twentieth century, when it became simply the *Nacional* Monte de Piedad. But its basic purpose has changed little, which is to offer small low-interest loans on pawned items to poor segments of Mexican society.

In recent years, the Nacional Monte de Piedad has grown into a large microfinance organization with over 150 branches throughout Mexico serving 750,000 borrowers totaling nearly 1 billion Mexican pesos (about US$75 million). The enterprise handles over 30 million pawned items each year in its warehouses. According to the latest information, Nacional Monte de Piedad charges 4 percent interest per month, and borrowers have 17 months to repay and recover their pawned goods. Commercial pawn shops in Mexico charge over 10 percent per month. After some years of poor financial results, Nacional Monte de Piedad recently resumed making grants to charitable organizations, one of its original purposes when it was founded in 1774. The institution is now offers small mortgages and home improvement loans to poor families, an expansion of services made possible by the improvement of Mexican institutions that define property and collateral.

Given the central role of the Catholic Church in governing Mexico during the colonial years, the Sacro y Real Monte Pio de Animas can be viewed as a type of government organization, as the current version, Nacional Monte de Piedad, clearly is. The size and clout of the organization, not to mention the omission of profit from its goals, enabled it to provide financial services at more favorable terms than profit-driven private microfinance organizations.

Note also that this example brings up the issue of whether interest payments are exploitative. The original Monte de Pietá and Sacro y Real Monte Pio de Animas charged no interest, as demanded by Roman Catholic doctrine. This rule reflects the church's attempt to stop the exploitation of debtors by wealthy financiers. The economic case for zero interest is that in an environment of zero inflation and near-zero per cent economic growth, there was not much of an opportunity cost to lending purchasing power to others; positive interest was thus viewed as a power issue, as powerful and wealthy people, who had money, could exploit the poor, who desperately needed money they did not have, by demanding payments for lending. Only the risk of default could justify interest, and the church in fact allowed for some payments to cover legitimate default risk.

Finance has often run into resistance from groups and religions that disapprove of the charging of interest on loans. Laws against "usury" still exist in many countries today. In some U.S. states, long-forgotten usury laws on the books have actually come into force with the growth of the predatory "payday loan" industry, sometimes charges annual interest rates of several hundred percent after all fees, charges, and interest are added together.

Islamic finance

Today, Islamic scholars still commonly interpret *shariah* (divine Islamic law) as prohibiting the charging of predetermined, guaranteed interest rates. There are today hundreds of financial institutions in nearly 50 different countries that practice what has come to be called *Islamic finance* or sharia-compliant finance.[4] There are also stock funds based in non-Islamic countries that invest only in companies that comply with Islamic principles, and even some of the world's major multinational banks engage in Islamic banking to attract savers and borrowers seeking shariah-compliant banking.

The belief that predetermined and guaranteed rates of interest go against Islamic principles is based on the prophet Mohammad's prohibition of *riba*, or "an excess." Many Muslims believe that social justice requires borrowers and lenders to share rewards as well as losses, which will not be the case if one participant in an intertemporal transaction has to pay a pre-determined rate of interest regardless of the success or failure of the project for which the money was borrowed. Thus, savings accounts that pay a predetermined rate of interest are not allowed, but mutual funds in stocks that pay dividends according to company performance are

[4] There are many accounts of Islamic finance; see, for example, Zamir Iqbal (1997), "Islamic Financial Systems," *Finance & Development*, June, or Timur Kuran (1995).

often acceptable. On the other hand, if the companies that pay variable dividends benefit from also borrowing at fixed interest rates, those dividends may not comply with shariah.

In many fundamental ways, Islamic finance is not different from the way financial markets work in most parts of the world. Islamic finance would efficiently allocate savings to the highest-return projects since that would be the preference of both lenders and borrowers. Clearly, lenders will be highly motivated to carefully examine potential projects and to monitor the management of the projects as well. However, lenders and borrowers who do not wish to share risk equally may be discouraged from engaging intertemporal transactions at all. And, because Islamic finance does not permit one party to an intertemporal exchange to carry all the risk, Islamic banks find it more difficult to offer savers shorter holding periods relative to the payoff periods of the banks' assets.

The recent expansion of Islamic mutual funds that invest in stocks, commodities, and leasing contracts suggests that some of the difficulties inherent to Islamic finance can be overcome. For example, the "securitization" of investments has permitted some reductions in risk through pooling while still, in principle, following Islamic law. And, the equal sharing of risk can actually enhance intertemporal transactions by preventing the instability caused by one side of the transaction carrying too much of the risk and thus being perceived as too risky to trust. Also, the closer synchronization of payoff periods and holding periods under Islamic finance reduces the chance that financial institutions cannot meet their short-run obligations.

The sharing of profits and losses by lenders and borrowers is actually quite appropriate for financing new entrepreneurs. The venture capital funds that have been so important in promoting new enterprises in the U.S. behave in much the same way as Islamic finance requires: if a new entrepreneur fails, the venture capital fund writes the project off, but if the venture succeeds, the lender takes a large portion of the profits. For ventures that have a high probability of failure, but which pay handsome rewards in the case of success, the standard fixed-interest loan is actually not very attractive because the lender stands to suffer the loss of most if not all the principal if the project fails but gains only a measly interest return while the entrepreneur captures most of the large gain in the case of success. This may be why banks traditionally favor lending to well-established firms and individuals over lending to riskier entrepreneurs with new projects. Just as the venture capital firm, the Islamic financial institution may be more likely to favor riskier but potentially highly profitable projects because it will share in the profits.

According to Kuran (1995), however, Islamic banks face a serious adverse selection problem. Most Islamic banks have gone to great lengths to charge fees that are in many ways similar to interest rates; fewer than 5 percent of loans made by Egyptian Islamic banks are reported to have been true risk-sharing arrangements. The reason Islamic banks effectively charge fees that result in returns that mimic fixed interest rates is they fear "that industrialists with high expected returns will borrow from conventional banks (to maximize their returns in the likely event of success), while those with low expected returns will favor profit and loss sharing (to minimize their losses in the likely event of failure)."[5] Risk sharing therefore implies an ever-higher effective interest rate, which drives away the less risky borrowers, as suggested three decades ago by Stiglitz and Weiss (1981).

There are other problems that Islamic finance has not been able to solve. The most important one is the apparent barriers it imposes on transactions between Muslims and non-Muslims. Because most of the world does not follow Islamic finance rules and principles, international investment by Islamic financial institutions is difficult. In fact, many countries where Islam is the dominant religion, such as Egypt, Indonesia, Malaysia, and many Persian Gulf

[5] Timur Kuran (1995), p. 162.

states, financial sectors do not generally practice Islamic finance. Islamic banks are thus faced with deciding whether they can lend to firms that also carry some conventional debt and Islamic stock funds must decide whether they can include stock in companies that have issued conventional fixed-interest bonds. Compounding these problems is the fact that religious principles are not consistently applied in different Islamic countries.

In sum, Islamic finance holds some advantages over other financial systems, and it suffers from some disadvantages. Its biggest barrier to expansion is its incompatibility with other financial systems, and this places it at a severe disadvantage in the increasingly global economy with its predominantly Western financial rules. The globalization of finance and the competition for individual depositors and borrowers forces everyone into the same molds, even though better alternatives exist for each specific financial circumstance.

Maintaining the commons without privatization

The story of the *tragedy of the commons*, a term introduced to the economics literature by Garret Hardin (1968), refers to many examples of how property not explicitly owned by someone ends up subject to over-exploitation. The term *commons* refers to collectively-owned resources, such as land or water, which each individual in a community can use for their benefit. Common ownership can end in tragedy because, it is claimed, unconstrained selfish individuals will not generally act in ways that maintain the long-run health of a commonly-owned resource.

The fish stocks in the oceans provide a current example of the tragedy of the commons. No one owns the oceans or the fish, and fishing activity is currently regulated, if at all, only in national waters by the individual nations that border the oceans. The stocks of the most popular types of fish are all being depleted. In the case of cod, often fished in international waters, they have effectively already been depleted. Individual fishers, fishing firms, and fishing cooperatives have often responded to the decline in their catches by aggressively improving technologies that permit them to fish even more intensively for the dwindling number of fish. Soon, we will no longer have many familiar fish that have been major portions of people's diets in many countries. You can surely imagine the tragic situation of a captain of a fishing boat, who knows he is contributing to the problem but has no alternative but to go out and fish because it would make no difference for one individual to stop fishing while everyone else continued fishing. Some decision needs to be made, and enforced, collectively.

The earth's atmosphere provides another obvious example of how individuals, firms, and entire nations continue to increase greenhouse gas emissions even though almost everyone involved knows that this is causing the earth's climate to change. The problem of the commons is that individuals, firms, or national governments closely allied with specific economic interest groups often have little direct incentive to stop actions that, collectively, are harmful to the future of the commons. Many opponents of restrictions on greenhouse gas emissions justify their opposition by asking: "What good does it do for us to undertake costly carbon-reducing measures when China and India will just continue expanding their emissions?"

Privatization is, therefore, often suggested as the best solution for protecting the resources currently in the various commons around the world. For example, the chief economist at Citigroup, Willem Buiter, argues for privatizing water, one of the critical resources that is becoming more scarce:

> I expect to see a globally integrated market for fresh water within 25 to 30 years. Once the spot markets for water are integrated, futures markets and other derivative water-based financial instruments—puts, calls, swaps—both exchange-traded and OTC will follow. There will be

> different grades and types of fresh water, just the way we have light sweet and heavy sour crude oil today. Water as an asset class will, in my view, become eventually the single most important physical-commodity based class, dwarfing oil, copper, agriculture and precious metals.[6]

Such a privatization of water and the trading of this privatized asset in markets is not without its problems. One very fundamental problem with privatization of the commons is that there are only two feasible ways to privatize large commons: (1) simply give ownership to someone and (2) permit someone or some business to bid on the resources using borrowed funds. Bids generally require financing because of the large sums involved. Thus, collective ownership is replaced by leveraged private ownership, which pressures the new owners to maximize profits for the duration of the finance period. Inevitably, the price of the resources rises for the users, and profits are captured by the new owners or their financiers.

Privatization is not the only solution to the potential tragedy of the commons, however. For example, Hardin (1968, p. 1245) suggested several possible strategies for dealing with commonly owned lands:

> We might sell them off as private property. We might keep them as public property, but allocate the right to enter them. The allocation might be on the basis of wealth, by the use of an auction system. It might be on the basis of merit, as defined by some agreed-upon standards. It might be by lottery. Or it might be on a first-come, first-served basis, administered to long queues. These, I think, are all the reasonable possibilities. They are all objectionable. But we must choose–or acquiesce in the destruction of the commons....

[6] Quoted in: Winonah Hunter (2012), "Climate Change and the Financialization of Nature," *Food and Water Watch* blog, downloaded on 5 May, 2012,

Elinor Ostrom (2005) explicitly warns against searching for a one-size-fits-all solution, such as privatization, for managing the commons. In fact, there are many alternatives for maintaining the commons. After analyzing a very large number of potential “tragedies of the commons” and efforts to deal with them, she identifies four types of “membership rules,” nine types of “personal characteristic rules,” and 13 “relationship rules” that can mitigate the problem. The first rules specify rules that define how one gains access to the commons, such as a membership fee, a government authorization, or a peer vote. The second refers to personal characteristics, such as gender, age, education, or skills. The latter category includes criteria based on a person’s relationship to the commons, such as a property right, a membership fee, or length of prior use. Note that these rules include both formal and informal social and economic institutions. Formal privatization is just one among many successful examples.

Ostrom (2009) found many groups that were able to organize themselves and thus make collective decisions to avoid a tragic end to the use of their common resource. The likelihood of successful commons management depends on society’s ability to establish good institutions to guide individual behavior. Ostrom argues that society’s ability to build such institutions depends on, among other things, the size of the commons, the importance of the commons for survival, the predictability of the effects of overuse, the number of users, the social organization of the users, and the quality of leadership. These factors differ greatly across countries, time period, and specific cases. Thus not all commons have tragic outcomes. However, Ostrom warns that with increased population pressure, increased resource use, and the increased complexity of human technologies, the tragedy of the commons may become more difficult to deal with. That is, it may become more difficult to act collectively to establish the right types of institutions to avoid future tragedies as the potential profits from resource ownership rise. The pressure for privatization will grow, and private groups will increasingly use government power to gain ownership.

5. Social security: A contemporary example of non-privatization

During the last few decades of the twentieth century, finance has certainly shifted increasingly to private arrangements using the vast array of modern financial instruments, traded through many types of intermediaries and markets, and addressing the demand for a great variety of inter-temporal and inter-generational exchanges. Still, many social inter-temporal arrangements remain, and some new ones have been developed. And contrary to what the anti-government rhetoric of the neoliberal doxa underlying the culture of mainstream economics, many of these social arrangements have outperformed potential privatized arrangements.

The U.S. social security system

The United States, like many other countries, has a national retirement income plan that is largely a "pay-as-you-go" system, in which current retirees are paid out of taxes on current working people. This plan pays out defined benefits, partially according to how much a worker paid into the plan, and partially depending on need. The program thus transfers from workers to retirees, and the payments have built into them a element of redistribution and insurance. This is not fundamentally different from what human societies have always done; those able to work support those who are no longer able to work.

A current problem with this traditional method of supporting the aged is that slowing population growth, after its rapid expansion during the baby boom years following World War II, implies increasing numbers of older retirees who have been promised benefits that must be paid for by taxes on the incomes of relatively fewer younger workers. To keep the system functioning, either taxes on workers must be raised or benefits to retirees reduced.

In 1983, when the problem first threatened the viability of the system, the government did both of those things: it increased the Social Security tax rate and it reduced benefits by raising the retirement age. These changes worked as planned, and according to projections by the Social Security Administration, the accumulated surplus means the system can make scheduled benefits until the mid-2030s. After that, some further tax increase or benefit reductions are needed to sustain the system beyond mid-century. The needed changes are not large, and there is plenty of time to put the changes into effect. But the political rhetoric, apparently fueled by the financial industry seeking to take over the inter-generational transfer system from their collective government management, has called for urgent and radical changes in the system.

The folly of privatizing social security

One proposal, first aired by the Bush administration in 2005, is to replace the entire system with a "fully funded" retirement system in which people contribute to their personal retirement accounts, which they can then redeem in the future when they retire. Such a system appears immune to population ageing because each retiree "owns" their account. But, in fact, the financial assets in the private are no less mere promises to pay in the future than the social security system's current promises backed by the government's power to tax. Even with privatization and individualization of retirement accounts, it will still be future income earners who will effectively pay future retirees.

A widely distributed report by the libertarian Cato Institute deviously omitted these transition costs in switching from the current pay-as-you-go system to a fully funded system. It may cost $10 trillion or more to pay retirement benefits to tens of millions of current and pending retirees who have not accumulated their own funds. The benefits of these retirees can no longer be paid out of taxes on current workers because, after the switch to private individual accounts, their tax payments go into their private accounts. Transition costs have to be covered by taxing the incomes of current workers, or if the government borrows, by borrowing and taxing future incomes. Thus, in order to gain a system immune to population ageing, the shift to private accounts requires current and future workers to pay taxes to cover the unfunded retiree benefits as well as their own private retirement accounts.

The Cato Institute also claims that a fully funded system would cause "a large net increase in national savings." In fact, a transition to a private system from our current transfer system requires increased taxes or borrowing that exactly offset the new saving by workers. Young workers' contributions to their personal retirement accounts would just cover the cost of buying the new government bonds needed to pay the benefits of current retirees. And, even after 100 years or more when the transition is complete and perhaps even fully paid for, a mature fully-funded system stabilizes with retirees taking about as much money out of their accounts as young workers put in. In short, a switch to private accounts generates no major flow of new savings for investment and innovation elsewhere in the economy.

Individual accounts have been described as giving American workers true ownership of and control over their retirement benefits. Realistically, Social Security privatization cannot give people much added freedom because the potential for bankruptcies, mismanagement, asset price fluctuations, and just plain bad luck means that very strict rules will have to be imposed to guarantee everyone a decent retirement. People will not be given the freedom to gamble with their funds because society would end up having to make additional payments to support those who lose their gambles. We will also need insurance to protect people whose funds go belly-up as well as strict government oversight of the funds to prevent the bankruptcies of overly aggressive financial firms that offer unrealistic returns to capture a share of the huge retirement market. There must also tight rules on withdrawals after retirement, lest some overly optimistic gamblers withdraw everything on the first day of retirement for a trip to Las Vegas to try to double their retirement fund. Finally, participation must be mandatory for everyone to prevent people with poor foresight from ending up broke and in need of government support when they are old. Thus, it is unlikely that a system of private accounts will give us much more freedom to invest and spend than the current system gives us.

The claim that a privatized system will generate greater returns for savers is questionable. For safety, the system will probably require savers to keep much of their savings in safe, low return investments like Treasury bonds, the same promises that currently back the social security system! We also do not know whether stock market returns will be as high in the future as they were the last century. Of course, if stocks do perform well because of a continued healthy economy, then a pay-as-you-go Social Security system will do well too because rising tax payments by wealthier workers permit higher retiree benefits. We should also remember that private individual accounts, which differ for each customer, are costly to manage compared to the current simple Social Security system. The annual cost of managing the entire current system costs much less than 1 percent of the payments made each year; even the Cato Institute

(1999), a libertarian advocacy group that actively promotes privatization of social security, admits that the administrative cost of running the social security system is not much more than $10 per participant per year.

Social security closely mimics historic social arrangements

There is actually no compelling case for privatizing the social security system. It is very inexpensive to operate, annually costing less than 1 percent of the payments made. The private financial sector normally charges much more for managing people's assets. Also, social security covers all workers, not just a select few with high incomes or those working for large businesses. Private asset management firms would be much more selective in who they would provide services for; to the extent that they would serve low-income workers, they would most likely charge more relative to the funds managed or provide explicitly lower quality services.

Most important, a private retirement system would not provide the added social insurance coverage that the social security system provides. Remember, by increasing benefits more slowly than tax revenues, social security in effect redistributes from high income earners to low income earners. Such as redistribution is a form of insurance on the unexpected turns that life takes. Despite what neoclassical economic models assume, individuals to not ever have full information with which to make decisions, nor can all eventual outcomes be accurately predicted. High income earners were, on average, luckier than low-income earners. Note here that the social security benefits still rise with income, just not proportionately. Hence, there is still a recognition or merit and hard work in life's success. The designers of social security were not doctrinaire egalitarian socialists; rather, they created a system that reflected the popular American belief in both merit for individual accomplishment and empathy for those less fortunate. It is unlikely that any private replacement for social security would contain such a sophisticated mixture of inter-generational exchanges. It certainly could not provide this mixture at the low cost.

6. Conclusions

Human societies have over thousands of years developed many practical ways to carry out inter-temporal transactions. What many economists now call *financialization* is, therefore, not fundamentally a new phenomenon. What is different, however, is the sheer volume of inter-temporal and inter-generational exchanges and the way societies carry out those exchanges. Traditional inter-temporal obligations were effected as part of a broad set of social arrangements and institutions, but today a much greater share of finance involves new financial instruments and institutions that make the exchanges more individualistic and personal. We refer to these two aspects of financialization is the *expansion* of finance and the *privatization and individualization* of finance, respectively. This paper then argues that these two components of financialization can expand at separate rates, and their effects on economic activity are fundamentally different. Hence, policies to deal with financialization need to explicitly recognize which aspect of financialization, expansion or privatization/individualization, they are targeting.

Judging from the literature, it appears that the most objectionable aspects of financialization are the privatization, and thus individualization, of finance. Indeed, the privatization of finance has many consequences, such as forcing businesses to focus more narrowly on the interests of major stockholders to the detriment of other stakeholders, enabling the capture of the political process by increasingly wealthy financial and allied corporate interests, and concentrating income and wealth in general. Also of concern is the growing frequency, and severity, of financial crises. And, despite years of financial innovation in the private financial sector, the large financial sectors of the most developed economies still have trouble dealing with informational asymmetries, moral hazard, adverse selection, fraud, risk, and the general uncertainty of human existence.

Modern finance's shift towards privatized finance has been shaped by both explicit and implicit criticism of collective action through government, aided by the false argument that privatization, and private ownership in general, leads to faster growth and more efficient inter-temporal economic outcomes. However, after examining the role of collective action in dealing with inter-temporal exchanges in both ancient and modern societies, it is clear that there are still very important roles for collective government actions. One thus wonders why the economics profession so often validates the arguments for privatizing finance.

Palley (2007) argues, in fact, that the economics profession has strongly supported privatization/individualization of finance, largely by justifying the neoliberal paradigm of privatization, free trade, international financial liberalization, reduced taxes on business and capital, reduced government safety nets, deregulation of labor markets, and central bank independence. Contemporary arguments for establishing property rights over nature, which would imply large increases in financial privatization/individualization, are an especially worrisome consequence of the dominance of the neoliberal agenda in the culture of the field of economics. As discussed in Van den Berg (2011, 2012), where I analyze the culture of economics along lines suggested by Bourdieu (1977, 2000, 2005), the dominance of one extreme paradigm reflects not just the fundamental failure of the field of economics to maintain scientific standards and provide unbiased analyses of economic phenomena, but it also reflects a well-entrenched subculture that continues bias economic analysis despite ample anomalies that contradict the field's principle methods and conclusions. This paper highlights yet another such scientific contradiction, namely the continued push towards the privatization and individualization of all types of intern-temporal and inter-generational exchanges despite the clear superiority of many social financial arrangements over privatized and individualized finance.

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