The dominance of finance

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Do we have an ethical framework that allows us to ask appropriate questions about the way in which the financial sector operates? Patrick Riordan SJ draws on a Vatican document and a book published in 2018 to explain why we need to ask particular questions about how the markets contribute to society – ultimately, do they make or take value?

> Experience and evidence over the last decades has demonstrated, on the one hand, *how naive is the belief in a presumed self-sufficiency of the markets, independent of any ethics …*

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This observation is taken from a 2018 Vatican document that draws on the tradition in Catholic Social Teaching of critiquing and reflecting seriously on cultural conventions, in this case the ethics of financial markets. The Congregation for the Doctrine of the Faith (CDF) and the Dicastery for Promoting Integral Human Development together issued the document with the long but modest title, *Considerations for an Ethical Discernment Regarding Some Aspects of the Present Economic-Financial System.*[1]

The performance of the financial sector has become a major influence on the shape of western economies following the wave of deregulation since the 1980s. The profits of financial firms in the USA peaked at 40% of domestic profits in the early 2000s, and recovered to 30% following the shock of the 2008 crisis. Even the later stabilisation at 20% shows how significant the finance sector is in generating wealth for those involved.

Not only does that wealth contribute to the scandal of the growing inequality in our societies, but the volatility of the markets raises questions about the lack of regulation and about how financial crises are allowed to affect the real economy (§§6, 14, 21). The unscrupulous behaviour of some bankers revealed in scandals such as the 2011-discovered manipulation of the LIBOR (London Interbank Offered Rate), and the marketing of expensive and unnecessary products such as PPI (Payment Protection Insurance) to trusting bank customers, provokes the need for appropriate ethics (§27).

Here is one of the questions worth asking in response to that need: The standard justification for the activity of the finance sector is that it contributes to the efficient allocation of capital to productive investment opportunities. But if it does that in fact, if it contributes to the efficiency of investment in productive activity, should we not expect to find a corresponding growth in returns in what is referred to as 'the real economy'? There is no evidence of such a correlation. The enormous expansion of the finance sector has not led to a parallel expansion in returns on productive investment. Of course, the crisis in the finance markets did have a destructive impact on the rest of the economy, but that was also due to the political choices made: to rescue banks with an enormous increase in the supply of money (quantitative easing) and to burden society with austerity to pay for the inherited debt. The evidence of a positive contribution to the productive economy commensurate with the growth of the financial sector is still lacking.

This point is made in a recent book, *The Value of Everything: Making and Taking in the Global Economy*. Written by a Professor of Innovation at University College London, Mariana Mazzucato, it follows on from earlier publications in which she challenges conventional wisdom and taken-for-granted assumptions in public discourse.[2] The value referred to in the title is not price. Value refers to the goods and services that are produced and distributed in our present economic systems. Those goods and services are understood to meet and satisfy human needs. The term value is interchangeable in some contexts with wealth, as when one speaks of wealth creation, or value making. Mazzucato focuses on the distinction between value *making* and value *taking*. Value making is to be celebrated, since it makes available goods and services that meet human need. Value taking, however, is not favoured, since beyond the satisfaction of legitimate needs it withdraws from the productive cycle important resources for further wealth creation. Her argument goes further in suggesting that those responsible for value taking have succeeded in reclassifying it as contributing to value making, and so they unfairly align themselves with the elements of our economic systems that are correctly celebrated.

A central conclusion of the book is that the finance sector is a value taker and not a value maker in our economy (chapter 4). This is a surprising and challenging thesis, given the role of the 'City' in the UK's economy and its importance for generating tax revenues. How does the author argue for this conclusion?

One strand of the argument is to look at the history of economic thought. Over the centuries, economic orthodoxy has shifted and the history of those shifts reveals changes in the way in which the boundary between productive and non-productive activity is drawn. The production boundary is a neat conceptual contribution to this discussion, helping us to notice some implicit distinctions that are not always adverted to: it distinguishes between those activities, professions or dimensions of life that contribute to the production of goods and services to satisfy human needs and wants, and those that benefit from but do not contribute to that production (p.9). Mercantilists, physiocrats, classical economists, and neo-classical marginalists all draw the boundary in different ways.

It has been generally assumed that finance in the form of banking does not contribute to production, it is a non-productive realm of activity. Similarly, at various stages, the charging of rent for the use of land has been viewed as a withdrawal of productive resources that does not itself contribute to production if not re-invested in improving the productive resource (p.72). So, for instance, the luxurious lifestyle of an aristocracy, supported by an agricultural system of production, is typically non-productive. This understanding of finance persisted until the neo-classical development of economic theory, which shifted focus away from the ends of production and distribution, and concentrated attention instead on the rationality of agents. Economic choices, whether to consume or save or invest, were to be analysed by means of a marginal calculus. Only where the agent expected a net return in terms of preference satisfaction would she undertake a particular action, and the action would continue up to the point, the margin, of net satisfaction. This approach could confirm a decision to hoard or consume as rational, and within the 'production boundary', because the measure of production is now deemed to be the satisfaction of agents' preferences, not necessarily the production of wealth in the form of provision of goods and services to meet human needs.

Mazzucato challenges the standard justification for the takings of the finance sector, which is that it contributes to the efficient allocation of capital to productive investment opportunities. Studies show that most established firms finance their research and development from internal resources such as retained profits, and do not depend on financial markets (p.104). Furthermore, initial financing for start-ups is rarely provided from the finance markets, investors only willing to become involved once chances of success have been established by initial performance. And it is in this context that she cites the observation with which we begun: that the enormous expansion of the finance sector, if it were contributing to the efficiency of investment in productive activity, might be expected to have resulted in a corresponding growth in returns on productive investment (p.109). In fact, she records that only 15% of the funds generated in financial markets go to businesses in non-financial industries (p.136). It appears that the enormous earnings in the finance sector are largely due to the churning of stocks by fund managers who benefit by charges on purchases and sales regardless of whether these have any impact on productive activity. Mazzucato's study also shows how this development in finance has infected the industrial sector, since any proposals to invest in new production will be compared with rates of return on the financial markets, and so resources are diverted in some cases (p.160).

What Marx called the 'bourgeois mode of production' – he did not use the term 'capitalism' although he wrote about capital – was innovative in comparison with the preceding feudal mode in that it relied on the retention and accumulation of earned income for reinvestment in the relevant productive activity. What is now called capitalism in popular parlance is a different entity, since so much of the income generated arises from finance markets, and that income is not invested in productive activity but, if at all, in the markets for financial products, stocks and shares, funds, derivatives, credit default swaps, and so on. This is sufficiently similar to the economy that grew out of the industrial revolution to continue to be recognised as a form of capitalism, but Mazzucato argues that the innovations in finance as a form of value taking warrant the qualification to Casino Capitalism (chap. 5).

The other feature of the current mode of production that Marx and other classical economists such as Smith or Ricardo would not approve of is the role of rent, and rent taking. Rent is derived from the monopoly control of some essential resource. At one point it was land; then credit; now it is largely an intangible such as social connection, or intellectual property: retired politicians, for example, quickly find themselves invited onto boards of directors of major firms because of their access to other important players. Company directors and executives who award themselves big remuneration packages, including stock options, are engaged in the same uneconomic activity of rent-taking, exploiting a power position to extract value: 'rent occurs when value is extracted through special privileges, for example a subsidy or tax break, and when a company or individual grabs a large share of wealth without having created it' (p.262).

Patents are held, and bought and sold, to derive income from knowledge that is essential for production. Mazzucato makes two points about patents and licences, which are forms of monopoly legitimised in regimes that appeal to the ideals of free competitive markets. The first concerns the role of governments in providing much of the initial research and knowledge generation, as well as cultural infrastructure: she notes that this role is conventionally disparaged by the ideology that relegates government to non-productive activity (the topic of her earlier book). Examples are the initial investment in the internet and in the microchip (p.220). The second adverts to the point of patents, which is two-edged. On the one hand, the registration of patents is intended to make knowledge about inventions and developments public and acessible, and to specify a future point in time from which such knowledge can be exploited without charge. On the other hand, the setting of that date creates a limited time within which the inventor can recoup costs of development by having a monopoly on the product. The use of patents, and adaptation of law to the lobbying of interested parties, privileges the latter purpose of protecting certain economic interests, to the detriment of knowledge dissemination, more critical for production (pp.202-6).

The authors of the Vatican's *Considerations* argue for the need for regulation of financial markets, but this may be counterproductive if it fosters cronyism and corruption.[3] Much more relevant is the challenge to assumptions and conventional wisdom contained in the document:

> … the asymmetrical concentration of information and power tends to strengthen the stronger economic agents and thus to create *hegemonies capable of unilaterally influencing not only the markets, but also political and regulatory systems*. Moreover, where massive deregulation is practiced, the evident result is a regulatory and institutional vacuum that creates space not only for moral risk and embezzlement, but also for the rise of the irrational exuberance of the markets, followed first by speculative bubbles, and then by sudden, destructive collapse, and systemic crises.[4]

Bold and challenging questioning of the kind exemplified in Professor Mazzucato's publications, to which we are invited by the Vatican's *Considerations for an Ethical Discernment Regarding Some Aspects of the Present Economic-Financial System,*[5] can help us to understand our economic reality, and develop an ethical framework accordingly.

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[1] Congregation for the Doctrine of the Faith & Dicastery for Promoting Integral Human Development, *Considerations for an Ethical Discernment Regarding Some Aspects of the Present Economic-Financial System* (2018): http://www.vatican.va/roman_curia/congregations/cfaith/documents/rc_con_cfaith_doc_20180106_oeconomicae-et-pecuniariae_en.html (accessed 25.01.2019); opening quotation from §21 (emphasis added).

[2] Mariana Mazzucato, *The Value of Everything: Making and Taking in the Global Economy* (London: Allen Lane, 2018). An earlier book, *The Entrepreneurial State: Debunking Public vs. Private Sector Myths* (London: Anthem Press, 2013) exposed the falsehood in the assumption that the private sector alone is responsible for the creation of wealth.

[3] See Mazzucato (2018), p. 252.

[4] *Considerations for an Ethical Discernment* §21 (emphasis added).

[5] *Considerations for an Ethical Discernment* §15.