*Collective Action and the Institutionalist Approach to Financial Regulation*

**Abstract** (144 words)

Drawing upon the Institutionalist approach to a capitalist economy as a Money Economy, I regard financial regulation and supervision as a collective action problem. I argue that given the basic characteristics of such an economy, financial system may be considered as a public utility and financial stability as a public good. I then maintain that the provision of the latter could not rely on private market mechanisms such as self-regulation and price-directed incentives. As capitalism develops through more financialized forms, new institutions and regulatory rules must be designed to reframe market's boundaries in order to consolidate systemic stability which is a basic condition for continuous and sustainable economic relations within society. A precautionary-principle-based macro-prudential approach to financial regulation is then suggested in the aim of ensuring a sustainable provision of finance and financial stability which is consistent with the characteristics of a Money Economy.

***Keywords:*** financial instability, financial regulation, Institutionalism, Money Economy, precautionary principle, public good.

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***Author***

Faruk ÜLGEN

Associate Professor

Director of the Department of Distance Learning Programmes and International Relations and Conventions, Grenoble Faculty of Economics

Centre de Recherche en Economie de Grenoble (CREG) – University Grenoble Alpes, France

faruk.ulgen@univ-grenoble-alpes.fr

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In the wake of the 2007-2008 crisis, a plethora of analyses sought to understand the roots of the catastrophe while the belief that liberalized market economies became crisis-free had gained ground and been used as an academic and political mantra since the 1980s. A few years later, emerging economies were stuck in a world-wide recession and the European Union rushed into a structural crisis that directed research towards studies on alternative monetary/fiscal policies to patch holes in a dissonant economy. Interrogations about an alternative regulatory framework were pushed into the background since some cosmetic measures were seen as sufficient transformations to lead to more resilient financial systems. So, a basic analysis of a monetary-capitalist economy can show that this evolution threatens the systemic viability of the entire economy if tighter macro-regulatory reforms are not implemented within the monetary and financial structure.

In order to design consistent reforms that aim at preventing recurrent systemic crises, this article draws on Institutionalist arguments and argues that the Institutionalist approach to a "Money Economy" (ME) offers considerable insight into how a relevant alternative financial regulation/supervision might be in order to mitigate the unstable dynamics of financialized economies. The "collective action problem" *à la* Commons or *à la* Olson is more accurately posed in the case of financial stability that every member of society needs but no one could provide at an individual level. The monetary/financial system can be seen as a public utility that requires a continuous provision of financial stability that can be seen as a public good. This calls for an institutional transformation of existing regulation/supervision to shape financial markets' strategies so as to ensure macro-stability. In this vein, the first section proposes some basic statements for an Institutionalist approach to money and collective action by studying the very characteristics of a ME. Drawing logically from these characteristics, the second section

shows the publicness of financial stability. The third section then states some minimal prerequisites in order to regulate the production of such a public good and to let the economy smooth-work in a sustainable way. The last section contains some concluding remarks.

## Institutionalist approach to money and collective action

The Institutionalist approach offers a relevant analysis of capitalism as a "Money Economy" to which money is a core institution so that capitalist society's evolution could be traced to the characteristics of money. Mitchell (1916, 157) states that money "is the root of economic science". In the same vein and in the tradition of Schumpeter, Kalecki, Keynes and Kaldor, Dillard (1987b, 1623) develops an institutionalist monetary theory assuming that money plays a central role in the economic process, and points to the theoretical weaknesses of the mainstream economics: "There is an old saying that everyone knows what money is except economists. When economists rush to their dictionaries, they find references to medium of exchange, unit of account, and measure of value. While there can be no quarrel with these definitions, they do not take us very far toward understanding money in the kind of world in which we actually live. For example, the dictionary does not tell us that the production of goods and services by which we live is a byproduct of the expectation of businessmen to "make money". This is also the Minskyian approach to capitalism: "In a capitalist economy the purpose of activity is to make money" (Minsky, 1986, 346).

Capitalism rests on a specific monetary-institutional structure that shapes society since all economic transactions require the use of money and generate various financial operations. A very crucial feature of such a money economy lies in the process of financing of decentralized-private decisions through the debt-creation-circulation-repayment cycle. In this "endogenous-money-environment", two society-wide constraints -organized through profit-seeking actors/markets-frame activities: financing constraint and repayment constraint.

1) *Financing constraint* means that every activity must be funded to become effective. This generates debt relations based on individual plans and actions that let decision-units undertake economic activities.

2) *Repayment constraint* means that debts have to be repaid according to their maturity. This refers to the condition that debt-financed-expectations[1] are realized and then allow debtors to fulfil their engagements vis-à-vis the creditors since all debts have to be repaid and no debt can be repaid by itself.

The debt-financing process and related financial operations make actors able to undertake activities *towards the future* notwithstanding their current asset/liability position. Money is the name of the payment system which is a set of rules/mechanisms that govern the creation-circulation-repayment process of debts, mainly relied to entrepreneurial expectations. Those debts flow through the entire economy and are used as money. *They are money*.

In such a societal/institutional framework, money has two society-wide/systemic characteristics. First, as it is generated as a means of financing through enterprise-bank relations money is a private-decision-related, individual-decentralized action system. At the same time, its use as a general unit of account, a means of payment and settlement of debts rests on its public character; every economic agent considers money as a public variable and accepts its society-wide use without calling into question its validity[2]. Standing as a public system of account-payment-repayment, money rests on nonmarket references that are public-common rules to keep its economy-wide validity though created in a private way. *Money is then an ambivalent variable: its private and its public*.

Second, money is everywhere, monetary/financial relations concern the whole society and the continuity of economic relations. Everything and everyone is everywhere directly/indirectly involved in monetary-debt-operations without necessarily taking directly part in the underlying

contracts. Every agent uses money, contributes to financial operations, and is affected by their systemic consequences and related policies without being directly involved in related transactions. Therefore *money is transversal and concerns every economic unit since it is generated and flows across the entire economy and individuals.* Although related to private decisions and interests, money and subsequent financial relations answer to society's needs and expectations, and generate societal consequences. From this point of view, money and finance can be seen as capitalism-specific public utilities. Without their regular provision capitalist society cannot develop. At the same time, their sustainable provision cannot rest on decentralized market mechanisms that evolve through uncertainty in a non-ergodic world. The provision of money and finance often requires policies and intervention of public power. The latter must stand outside of the market relations as a general-society-referee and seek to organise, regulate and supervise the production, the use and the evolution of the monetary/financial system.

To date, as capitalism develops through more financialized forms, new institutions (the working rules *à la* Commons[3]) emerge to govern economic and social relations. A specific "collective action problem"[4] comes into the picture as a relevant way of developing a monetary institutionalist approach to capitalism that could lead to reframe finance according to the needs of socially sustainable activities in order to ensure their durable funding and prevent systemic instabilities that harm economic and human development.

Economic relations rest on the feasibility of continuous payment and settlement operations which require financial stability that nobody can ensure because of the impossibility to organize such a system-wide control-and-checking process at an individual level. Therefore any institutional transformation must provide economies with relevant public regulation/supervision that could consolidate macro-stability. [5]

## Publicness of financial stability

The economics profession usually admits that market mechanisms can price everything in an efficient way but in some "residual" cases it may fail to provide adequate supply. Public goods belong to those cases of market failures that often call for public intervention (Sobel, 2004). Two distinct criteria can be used to assess the publicness of an economic variable. The first rests on non-excludability and non-rivalry of the good. Since the good is not scarce and not priceable it cannot be provided by markets in an economically efficient way. Samuelson (1954, 387) identifies public goods as collective consumption goods that all enjoy in common "in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good." This is the "jointness of demand": once produced for some consumers, the good can be consumed by additional consumers without reducing its (qualitative and quantitative) availability for the others.

For Musgrave (1959) the exclusion determines the publicness of a good: whether or not someone can be excluded from its use. Olson (1965: 14) states in the same vein: "A common, collective, or public good is here defined as any good such that, if any person Xi in a group X1...Xi...Xn consumes it, it cannot feasibly be withheld from the others in that group." Therefore individuals who do not pay for it cannot be excluded from accessing to the good. However, Kaul et al. (2002: 80) maintain that since society can modify the (non)rivalry and (non)excludability of a good's benefits, "Goods often become private or public as a result of deliberate policy choices". The ultimate position of an activity as a public or a private good will depend on the characteristics of the good with regard to the aims/values of society within which its production is required. Malkin and Wildavsky (1991) argue that the boundary between private and public goods is socially constructed.

The second criterion is more related to the (societal) criticalness of the need for such goods that cannot be efficiently addressed by private optimisation plans. Musgrave (1959: 44) maintains,

for instance, that a public good is a good whose inherent quality requires public production. Nordhaus (2010) asserts that in case of public goods, there is no workable market mechanism able to give appropriate incentives to make the production of goods efficient.[6] Ostrom (1990, 2003) argues in terms of costs and maintains that whereas individuals would all benefit from the provision of a good/activity, they cannot realize it at their individual level given its production costs. Olson (1965: 2) states: "…even if all of the individuals in a large group are rational and self-interested, and would gain if, as a group, they acted to achieve their common interest or objective, they will still not voluntarily act to achieve that common or group interest."

Whatever the definition chosen, the issue is related to market inability to provide society with this good/activity. The basic problem lies in the fact that market-prices-oriented micro-rational decisions do not spontaneously result in a consistent provision of the prerequisites for the entire economy. So when it comes to financial stability, the public good is a society-wide concern related to a specific activity that entirely involves economy in its production and consumption[7]. Financial stability is a macro/systemic concern which cannot be provided by micro decisions. First, the information and perspective required for thinking of macro-stability are not available at an individual's level. Second, individuals cannot undertake decentralized and partial micro operations to make stability sure at a systemic level. Financial instability must then be handled at a systemic level as a public good. Moreover, regarding the publicness of financial stability, the Coasian-Neo-institutionalist perspective cannot be used because it is not possible to conceive, through a redefinition of some property rights, that the externalities that could stem from private financial activities could be internalized within the market mechanisms and then let markets generate spontaneous responses to financial crises. Indeed, once a systemic financial crisis happens, there is no possible compensation that could conceal or offset the

negative consequences of the previous crisis-generating decisions over the entire economy. The solution then relies on the possibility of collective provision -through collective action- of the good. Once common rules and socially optimal design are established by some collective-action mechanisms, they are available to each actor and every individual and/or institution can get benefit from without suffering costs of instability[8]. A specific collective action problem then arises with regard to the design and implementation of relevant regulation mechanisms.

## Financial stability and Public good regulation

Since the 1990s we are all familiar with recurrent financial instabilities that regularly threaten the viability of market-based economies. The design of financial regulation and provision of financial stability become a collective concern that does not seem to be adequately performed by self-regulatory practices. In the production of peculiar public utilities such as money and finance, a peculiar public service -financial regulation/supervision- must take the form of collective action irrespective of the private actors' interests. In this way, Minsky (1978) explicitly puts the emphasis on the institutional framework that underlies the financial system[9]. His Financial-Instability-Hypothesis approach focuses on finance and financial markets' changes and regards capitalist economy in terms of endogenous cyclical behavior through the linkages between finance and investment/business. Minsky (1982) argues that sustainable economic relations call for a "good financial society" that prevents agents from engaging in speculative finance. Minsky maintains that the conception and management of money and financial markets should be designed according to some collective rules and regulations in order to prevent systemic catastrophes.

The macro-prudential approach to financial regulation that rests on the precautionary principle might lead to a sustainable provision of these public utilities (monetary and financial system that makes possible financing of the economy) and of public goods (financial system's stability

that makes the capitalist accumulation and reproduction possible)[10]. Macro-prudential regulation deals with systemic risk and aims at limiting the likelihood of a generalized failure. Macro-prudential rules have then to be designed for the system as a whole (top-down approach). Macro-prudential regulation is the relevant supervision alternative since micro-regulatory frameworks cannot address the systemic concerns and deal with counter-cyclical and systemic needs to stabilise the whole economy. Crockett (2000) states that the macro-prudential dimension consists of regarding system outcomes as endogenously determined by the overall markets while the micro-prudential dimension considers those outcomes as exogenous to the individual institutions and cannot include feedbacks of collective actions on the condition of individual institutions. Crockett (2000) then documents that the macro-prudential paradigm stresses the possibility that actions that may seem desirable or reasonable from the perspective of individual institutions may result in catastrophic system outcomes. This is the incompatibility between micro decisions and macro stability. The former relies on individual institutions freedom of action without relevant global view while the latter requires non-market-dependent, tight and regular public supervision.

From this perspective, the rationale for the precautionary-principle-based macro-regulation is related to the necessary production and conservation of public goods and reduction of market-activities-related harms to society. A "Three-Rule Regulatory Model" might offer a first proxy for such an alternative:

- The rule of prevention and forward regulatory action: financial activities with potential systemic risks are prevented and institutions that would undertake such activities must provide the proof of harmlessness;

- The rule of continuous no-private-interests-related checking process: regular reporting by public regulators under the supervision of nonmarket public authority in order to prevent

confusion between the socially-needed-systemic-stability and profit-seeking-activities-related assessment procedures (for instances, private agencies' ratings and banks' internal ratings based procedures);

- The rule of separation between regulator and regulatee to prevent the conflict of interests: rating and advising activities must be insulated from each other and rating agencies must be prevented from confusing both activities.

The implementation of macro-regulation needs a stronger coordination/cooperation agency which must aim at strengthening conditions of provisioning of this peculiar public good, financial stability, essential for economic and social sustainability in capitalist societies. Epstein et al. (2009) point to numerous crucial flaws of financialized economies that are dominated by speculative ardor such as financial and economic instabilities, inequality, weak economic and social performance, and suggest alternative social governance structures to replace financiers dominated financial systems. These social governance structures should counterbalance the attractiveness of destructive financial practices. In this aim, the precautionary principle can offer an appropriate financial regulatory guide in order to keep under control speculative activities that could generate significant societal damage.

## Conclusion

In the wake of the catastrophic consequences of the 2007-2008 crisis, the economics profession should renew its basic lessons about the nature and the working of market-related (and the like) economies. Indeed the economics are in a need to move from market efficiency hypothesis to the study of institutions of capitalism as a monetary and uncertain economy. From this perspective, this article sought to show that viability of society relies on the institutional transformation process that aims to provide economies with relevant public regulation/supervision in order to shape financial market behavior so as to strengthen system—

wide stability. This institutionalist analysis leads to a precautionary principle-based macro-prudential regulation that could sustain continuous provisioning of money and finance (public utilities) and of financial stability (a public good) in a consistent way regarding the characteristics of a Money Economy.

The liberalization of financial markets increases the need for public oversight since it results in a system-wide financialization with continuous and permanent effects on the economy. Therefore, financial system's stability appears to be a general concern that should be regarded at a macro level and dealt with through collective action mechanisms aiming at structurally strengthening financial markets and related regulatory/supervision framework.

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[1] Economic operations gain momentum thanks to continuous debt-financing process.

[2] This is called “trust in money” that mostly rests on the general validity and acceptability of monetary rules that govern economic relations. When the rules in force do not ensure anymore monetary validity and stability, domestic currency is partially or entirely replaced by another currency (the so-called dollarization phenomenon).

[3] Commons (1934, 80) defines “a working rule” as the universal principle that can be derived “from all observations of collective control, liberation, and expansion of individual action, whether it be a going concern or a custom…”. Commons (Ibid., 92) also states: “The working rule is not a foreordained harmony of interests, as assumed in the hypotheses of divine or natural rights, or mechanical equilibrium of the classical and hedonic schools, but it actually creates, out of conflict of interests, a workable mutuality and orderly expectation of property and liberty.” So, Commons maintains that all the different aspects of society (conflict, dependence, order, working rules, etc.) are the field of institutional economics and correlated under the notions of collective action that controls individual free action (Ibid.)

[4] Collective action can be considered in terms of formal organizations like the property rights. It can also be defined as voluntary action chosen and implemented by a group to achieve interests. It can be instituted through common property regimes or through coordinated activities across individual units. (See, among others, Meinzen-Dick and Di Gregorio, 2004). In this article, I relate it to the necessary organization and management of financial market supervision by supramarket/nonmarket public-good seeking entities.

[5] The same argument also holds for the international monetary/financial system. International relations rest on the regular implementation of payment and settlement rules while the required financial stability cannot be provided by individuals or individual states. Financial rules and mechanisms must be (re)framed through international cooperation and coordination. To be sustainable and humanly consistent, this must be framed and managed according to the financial needs of socially relevant activities in order to ensure their viable and durable funding and to prevent catastrophic systemic instability.

[6] Nordhaus (2010: 1) also states that for global public goods "there is no market or government mechanism that contains both political means and appropriate incentives to implement an efficient outcome. Markets can work wonders, but they routinely fail to solve the problems caused by global public goods."

[7] The nature of financial stability as a public good is not taken here through the theory of groups and the supposed ubiquity of organizations. It depends on the system-wide characteristics of monetary/financial relations.

[8] Although beyond the scope of this article, it is worth noting that the collective action problem of public goods applies well to global public goods: "Even if there is general agreement that the potential gains from international concerted action are great, there is no supranational government authority to devise and impose solutions as the norm at the national level (e.g.

taxation, regulation, market creation)" (Sagasti and Bezanson, 2001: iv). International monetary/financial system's stability can be seen as a genuine international/global public good. When the system works well, all countries get gain from international flows of products and capital and when it breaks down, nations become unable to sustain high levels of trade and investment.

[9] Minsky (1978, 5) states: "The Financial Instability Hypothesis which is rooted in Keynes differs from what is explicit in Keynes and other post-Keynesian economists in that financial institutions and usages are integrated into the analysis."

[10] It is worth noting that financial stability as a supra-individual perspective is a prerequisite for stable and durable micro-efficient market behavior.