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From the Crisis of Financialization to the Covid Crisis: In Search of a Collective Action Between Market and State

Abstract (207 words):

This article is an exploratory essay on the possibility of governance of financial systems beyond the opposition between market and state to improve financial stability. Financial system governance is a set of rules and practices that should allow sustainable organization and management of markets. It closely relies on financial regulation in force. This article assumes that the monetary/financial system is a core institutional framework whose stability is of utmost importance and requires specific collective action to face social dilemmas that result in systemic concerns. Two analytic perspectives are used to frame a relevant collective action model: polycentric governance à la Ostrom & Ostrom, that fits the cases of common-pool resources, and Minskian institutionalist perspective that fits the analysis of endogenous instabilities. A distinction criterion between these two perspectives is then suggested: If an issue has a global character (societal criticalness of public goods), it would fit well with a

"power-over" coordination framework whereas more local elements (the commons) could be governed through polycentric "power-with" mechanisms. The rationale for macro-prudential regulation against systemic failures is then put forward under the supervision of extra-market public agencies in charge of global coordination over local regulatory institutions in order to increase the flexibility and the speed of responses to growing instabilities.

Keywords: Financial crises, financial regulation, polycentricity, public goods

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Introduction

Financial (in)stability is a central concern for the smooth working of market-based economies. Recurrent systemic crises call for alternative sustainable models of financial regulation. Public vs private regulation provides the traditional conceptual frame of such an issue. This article questions the relevance of another perspective, the co-regulation for financial stability between decentralized private-interest view and centralized public-interest vision. The article liberally draws upon polycentric governance à la Ostrom & Ostrom as a collective regulatory action mechanism. A holistic institutionalist perspective is also suggested on the Minskian problem of what might be the possible palliative therapy to mitigate capitalism's tendency to produce systemic financial disasters. This issue is a general *collective action issue in face of socials dilemmas:* "How can relevant financial regulation be framed in order to strengthen the sustainability of financial systems whereas individual institutions rationality does favor profitable strategies that might harm systemic stability?" Collective action aims at solving social dilemmas that can result in crises of societal magnitude like the financial crisis of 2007-2008 and the current Covid-19 pandemic. It is obvious that in economic life, *financial stability* is to the viability of economy what public health is to the lives of citizens. The relevance of collective action relies on sustainable organization of economic activities and

markets that should prevent the strike opposition between individualistic private-interest view and public-interest monocentricity.

The core thesis of this analysis is that the financial system displays the features of a basic infrastructure common to the whole society. Relying on a few characteristics of public goods (size, scope and criticalness), I suggest a distinction criterion between commons and global public goods that depends on their relative systemic criticalness: If an issue has a global character, it would fit well with “power-over” governance (for instance, systemically important financial institutions), whereas the more local aspects (the commons) could be governed through polycentric “power-with” mechanisms (local, cooperative banks, for instance). The rationale for macro-prudential regulation against systemic failures is then put forward under the general coordination responsibility of extra-market public supervisors along with more flexible procedures of community-based regulatory institutions directly involved in local operations.

Three sections develops this analysis. The first section presents an overall view on the regulation and governance issues in relation with the characteristics of public goods. The second section develops on polycentric governance and focuses on its scope as a regulatory alternative to solve social dilemmas. The third section proposes a Minskian institutionalist reading on unstable financial dynamics and considers the efficiency of regulation under two constraints: flexibility and rapidity of decisions and actions to face systemic concerns thanks to multi-level governance, and coherent coordination at the global level to deal with the problem of provision of a critical public good, financial stability. The last section concludes.

Institutions, regulation and governance

As Ostrom (2010a) remarks, solving global problems require collective action through efficient and fair mechanisms. The design and implementation of collective action rely on the

regulatory and governance framework that depends on the institutional structure. The latter should allow markets to choose actions with regard to the dynamics that could generate collective concerns. The governance issues point to the systemic importance of institutions to organize and manage the regulatory framework in a way that should be consistent with societal sustainability. This general statement applies to the economy as well as to other issues of societal importance (current health crisis, global political conflicts, etc).

Regulatory framework is a set of explicitly/implicitly, formally/informally institutionalized rules and practices that lead to sustainable governance of society. Institutions are the determinants of the governance system since regulation closely relies on institutions that make the implementation of rules and practices possible over time. As a set of restrictions/constraints imposed over individual/market activities through a binding set of rules, usually implemented by the public power to influence business or social behavior, regulation aims at preventing actions that might harm society and/or seeks to facilitate/encourage/incite actions to enhance society's welfare (Baldwin et al. 2012). This results in an opposition between public-power-related regulation and private-decisions-related market activities; between the two faces of society: public interest and private interest, between micro-rational behavior and macro-rational governance.

There are also two opposite ways of considering regulation under public control. One way is market-interest related: "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit" (Stigler, 1975: 115), even if one can positively assume that "political systems are (…) appropriate instruments for the fulfillment of desires of members of society" (Ibid.) Another way regards regulation as a support system that seeks to supply to society "a structure of beliefs that make prosperity and liberty possible (…). Regulation, in other words, in some sense creates the very possibility of marketplaces" (Carpenter, 2009: 164).

Various theoretical and political approaches to regulation build on the distinctive features of the products/activities that usually lead to the separation between public and private goods. Private (market) goods are the products that can be provided by market mechanisms[1] while public goods cannot be provided by markets and require extra-market interventions.[2]

In line with Samuelson (1954), Musgrave (1959), Olson (1965), Ostrom and Ostrom (1971, 1977), Selmier, Penikas and Vasilyeva (2014), Boonen et al. (2019) and Carlisle and Gruby (2019) (to quote but a few), Ülgen (2021) provides a synthesis on different criteria used to identify the characteristics of private/public goods and their social provisioning process. Beyond the rivalry and exclusion, that reflect the property right-based market provision process, the size-and-scope related *societal criticalness* is also relevant to identify the publicness of an activity. The inability of markets to fix prices that would balance the social costs/benefits and the private costs/benefits leads to socially non-optimal outcomes: "Where there are negative externalities, the market allows too much activity. Where there are positive externalities or public goods, the market provides too little activity" (Congdon et al, 2011: 108). As Hardin (1968) stated, *The Tragedy of the Commons* has no obvious "technical solutions" since, contrary to the Smithian statement, individuals who intend their own interests do not promote the public interest[3].

In what E. Ostrom (2010a) calls "the conventional theory of collective action", an external authority is called to impose enforceable rules to give the correct incentives to shape individual behavior and, without externally imposed regulation, there could be no solution to

[1] "Market mechanisms" are all economic relationships between parties that seek to produce/consume products in order to achieve some private interest/satisfaction. The resulting supply and demand would move up and down with price changes (and vice-versa).
[2] "Public interventions" are any activities whose provision relies on decision/implementation process that is not directly linked to private profit-satisfaction patterns, although they could take hybrid forms (mixture of public-private cooperation). These activities exist because of the absence of a spontaneous bridge between private and public interests that would allow markets to provide any macro-level needs in society in a sustainable way.
[3] In other words, public goods cannot be provided by short-term benefits of private individuals that rely on market behavior, seeking high returns regardless of their possible costly negative effects on the rest of society.

global problems (Brennan, 2009). This view is also related to the publicness of the issue to be treated through collective action. Obviously, this is a social dilemma situation such that "an optimal behavior of an individual contrasts with the optimal outcome for the group" (Archetti and Scheuring, 2012: 9).

The regulation of financial systems falls under such dilemmas. Given the critical role financial systems play in economic development, the stability of financial markets is a central concern for the smooth working of market-based economies.: "The governance of the financial system is a special case of the broader problem of building a resilient governance system – a system that can reliably deliver public goods and cope with unexpected shocks" (Salter and Tarko, 2019: 506).

A "middle" way to ensure regular and stable provision of financial activities might be polycentric governance of markets between tight state control and loosely regulated free markets.

Polycentric governance

In the face of diversity of issues stemming from human interactions in complex societies, coherent organization and management of economic relationships is traditionally studied in terms of dichotomy between market-relying and state-relying governance frameworks. This dichotomy usually results in a fierce opposition between private interests and public interests, between the public good and the private good[4]. Another perspective is what Vincent and Elinor Ostrom sought to develop through "polycentric governance" as a community-relying, local dynamics-based, and more flexible way of taking care of the common resources and avoiding the Tragedy of the Commons. Ostrom et al. (1961: 831-832) state that "polycentric"

[4] The well-known theoretical and political conflicts between Classical, Neoclassical, New classical approaches and Keynesian, Post-Keynesian, Marxist and Institutional approaches can all be linked to such an opposition.

means involvement of many centers in the decision-making and that these centers are formally independent of each other. However, they would function as a coherent system: "To the extent that they take each other into account in competitive relationships, enter into various contractual and cooperative undertakings or have recourse to central mechanisms to resolve conflicts, the various political jurisdictions in a metropolitan area may function in a coherent manner with consistent and predictable patterns of interacting behavior".

E. Ostrom (2010a: 555) also maintains that "when individuals are well informed about the problem they face and about who else is involved, and can build settings where trust and reciprocity can emerge, grow, and be sustained over time, costly and positive actions are frequently taken without waiting for an external authority to impose rules".

Archetti and Scheuring (2012: 10) then argue that some specific circumstances (such as repeated interactions that would allow reciprocation, reputation and punishment, and kin selection) might provide general solutions to the problem of the evolution of cooperation through mixed equilibria in public-good games with a certain level of cooperation. However, Archetti and Scheuring (2012: 18) maintain that their analysis points to the necessity of a prescriptive approach to public goods.

In line with Selgin and White's (1994) Free banking approach and against top-down government regulations, Salter and Tarko (2019: 508) maintain that: "the only way in which a complex system can be made resilient is by giving up the goal of maximum short-term efficiency, keeping the scale low, and implementing redundancies. The emphasis on polycentricity and diversity, i.e. preserving a redundant variety of institutional devices rather than adopting a one-size-fits-all solution, should be understood from this perspective." The regulations are expected to be endogenously generated by the market actors rather than exogenously by a top-down government intervention. However, the Authors add that in such a decentralized regulatory system, the constituent organizations have to be governed by an

overarching set of rules aiming at aligning the information and incentives of individual actors with broader social goals such as financial stability. These rules should be supported by mutually agreed procedures for monitoring and enforcing agreements that punish behavior which is privately beneficial but socially costly.

Following the results presented by Ostrom (2010b)[5], it is worth recalling the general conditions under which polycentric governance could be expected to be efficient:

- The publicness of goods may vary from low to high under specific conditions and then require a more or less polycentric organization then a monocentric public hand-guided governance.

- Multiple-scale provision seems easier when the scale of production and the size of the organization required are small.

- Therefore, a horizontal hierarchy is possible in a regular and open meeting-and-consultation environment within which all players can be involved. Such a "direct democracy" may allow simple, flexible and permanent communication among the members of the community through "cheap talk" mechanisms.

- Characteristics of the actors involved, their respective position (power, obligations, interests, etc.), set of actions actors can take, and the map of functions within the collective game as well as the consequences of such actions on the provision process should be posited.

Under such conditions[6], one might expect efficient outcomes from "the potentially productive efforts of individuals and groups to organize and solve social dilemmas such as overharvesting of common-pool resources and the underprovision of local public goods" (Ostrom, 2010b: 8).

[5] Indeed, Ostrom argues that subtractability of use (instead of rivalry) and excludability should be assessed from low to high rather than characterizing them as either present or absent since even the so-called "pure public goods" might be subtractable and/or excludable under some specific circumstances.
[6] Obviously, these conditions are also related to the identification of the (property) rights of the actors involved in the provision and consumption process. Although essential, this issue will not be addressed in this article.

In light of these assumptions and results, to what extent could it be argued that financial markets might be regulated without public power-relying, non-market supervision?

To answer this question, I argue that given the central role of monetary/financial operations in the economy and their unstable dynamics, systemic stability cannot be expected from markets self-adjustment. It has to be organized and managed by a society-wide collective action plan that I call "the visible public hand.[7]

Endogenous instability and exogenous regulation

The assumptions in favor of polycentric governance rely on the possibility of coherent community-based organization of the provision of the commons. This possibility is closely dependent on the characteristics of the good to be provided.

It is now well documented in the literature that financial markets recurrently exhibit collapses at a systemic scale. Although such instabilities may be sometimes triggered by unpredictable stochastic events, "More often, however, there have been endogenous underlying processes at work. Instability does not come suddenly but can develop gradually through unnoticed loss of resilience" (Battiston et al. 2016: 818).

Minsky (1986) argues that serious business cycles are due to the financial attributes that are essential to capitalism. Minsky states that capitalism as a private debt-financing economy is naturally unstable: "The tendency to transform doing well into a speculative investment boom is the basic instability in a capitalist economy" (1982: 66). This "Financial instability hypothesis" (FIH) is built up on the study of the endogenous dynamics of the evolution of

[7] Although beyond the scope of this paper, "visible public hand" proposal might be thought through the literature on the well-known opposition between "rules and discretion" regarding the design and implementation of economic policies. Visible public hand might be considered as a set of previously announced and tightly implemented rules by public agencies, delimiting their scope of intervention. It can also be regarded as a visible and permanent oversight of the public power over the markets even though the interventions might take a discretionary shape in order to keep market behavior and expectations under continuous pressure about the intensity of the interventions.

financial systems. From this perspective, Ülgen (2022) argues that a capitalist economy can be identified as a monetary economy that works through continuous and expansive debt relations.[8] The latter provide the means of financing decentralized and private economic decisions without any central plan and public oversight. Therefore, such an economy is inherently a debt economy that needs viable and sustainable extra-market rules to ensure the society-wide validity of the process of circulation and repayment of debts, a necessary condition for wealth accumulation on a large scale.

A crucial aspect comes then into the picture: the financial system displays the features of a basic infrastructure common to the whole society whose stability proves to be a public good and a societal concern. A few distinctive criteria (size-scope and systemic/societal criticalness) of the activities to regulate allow to set the conditions for a relevant regulatory framework: If an issue has a global character, it would fit well with top-down-like “power-over” governance (for instance, systemically important financial institutions), whereas more locally providable commons could be governed by bottom-up, polycentric, “power-with” mechanisms (local, cooperative banks, for instance).

If financial stability proves to be rather a global concern than a local issue, the rationale for macro-prudential regulation against systemic failures should lead to a global governance of collective action. Therefore, the regulation/supervision of financial systems as a whole (macro-prudential) falls under the responsibility of public bodies, above and beyond the markets/private actors. In some specific cases, elements of governance may be entrusted to local institutions in order to increase the flexibility and speed of regulatory measures. Power-over and power-with, local and global cannot exclude each other when it comes to systemic financial stability.

[8] In a comparative analysis between Public Choice and Institutionalist approaches regarding financial system governance, Ülgen (2022) states that two important aspects can be found at the intersection of Institutionalist and Post Keynesian economics: a monetary theory of production and the hypothesis of endogenous money, both allowing the identification of a capitalist economy as a monetary economy.

Some relevant directions for systemically consistent (global) measures might be given through works developed in the aftermath of the 2007-2008 global financial crisis. For instance, Acharya et al. (2009: 283-284) suggest that the regulator in charge of systemic risk would act like the *headquarters* of the economy, and each individual firm would be considered as a component of the system. Two major aspects of regulation are considered: the measurement of systemic risk and the level of potential contribution of each financial institution to systemic risk. In order to prevent moral hazard (allowing incentives for firms not to take on excessive systemic risk) and the pro-cyclical speculative behavior of markets, but also to involve private institutions within the rules of the game that consists in dealing explicitly with systemic risk, two sides of governance have to be framed: systemic-risk management at the macro level (overall regulation of markets) and a market-based system to involve the individual responsibility of firms according to their contribution to systemic risk[9]. As Ostrom (2010a: 555-556) states: "Self-organized, polycentric systems are not a panacea! There are no panaceas, however, for complex problems such as global warming. Besides the general benefits that a polycentric system can generate, there are also threats (…) The advantage of a polycentric approach is that it encourages experimentation by multiple actors, as well as the development of methods for assessing the benefits and costs of particular strategies adopted in one setting and comparing these with results obtained in other settings."[10]

[9] A very relevant proposal of such a regulatory framework is the individual contribution to aggregate risk through ex ante capital requirements and capital insurance. In the event of a payoff on the insurance, the payment should not go to the firm itself, but to the regulator: "This would provide incentives for a company to limit systemic risk (to lower its insurance premium), provide a market-based estimate of the risk (the cost of insurance), and avoid moral hazard (because the firm does not get the insurance payoff)" (Ibid. 284).
[10] A similar remark is also provided by Selgin and White (1994: 1743-44): "Laissez faire does not usher in Nirvana; neither do legal restrictions or government bureaus. Institutional arrangements under any regime must come to grips with the inescapable information and agency costs of securing desired behavior from those who issue money or regulate its issue."

Conclusion

In a market-based capitalist economy, financial operations are at the heart of economic dynamics. Financial stability is a society-wide concern and should be addressed at macro level as a social dilemma through collective action to ensure a continuous/stable provision of monetary/financial operations. Such an issue is related to the design of institutions, expected to allow consistent governance for systemic stability. Cleaver and de Koning (2015: 12) note: "institutions are formed in the interplay between the creative exercise of agency and the often constraining effects of social relationships, environments and the workings of power. (..) In embracing plurality and complexity, how can we produce analyses of complex and dynamic institutional processes which are broadly legible to policy and public decision making?"

This article considered the relevance of polycentric governance with regard to the characteristics of financial activities and their stability. The systemic criticalness is suggested as a distinctive criterion between public goods and common-pool resources. Under the endogenous financial instability hypothesis, if financial stability has a global character, it would fit well with power-over governance, whereas the more local aspects could be governed through power-with mechanisms. The article then points to the rationale for macro-prudential regulation that could be reinforced by market-based schemas and local governance in order to increase the efficiency of regulatory measures.

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