What Do Capital Markets Really Do?:

and What Should We Do About Capital Markets?

Steven Pressman
Monmouth University
Department of Economics and Finance
West Long Branch, NJ 07764

This paper examines the role of capital markets and the relationship between the financial and real sectors of developed capitalist economies. It rejects the neoclassical view that capital markets exist to efficiently allocate resources so that the real economy can operate more productively. Instead, it argues that financial markets exist to redistribute wealth. More wealth in financial markets gives affluent investors greater influence over the real economy, and greater influence over economic policymakers. The paper concludes by rejecting transactions taxes on the sale and purchase of stock as a means to curb speculation. Instead, it favors policies that "level the playing field" by broadening the ownership of capital assets, and making it easier for everyone to play the grand redistributive game that takes place in capital markets.

Ce texte étudie le rôle des marchés du capital et la relation entre les marchés financiers et les marchés des actifs réels dans les économies capitalistes. Ce texte rejette l'interprétation néoclassique : il faut que les marchés financiers existent pour réaliser l'allocation efficiente des ressources financières et donc permettre à l'économie réelle d'être plus productive. Tout au contraire, ce texte prouve que les marchés financiers existent pour redistribuer la richesse. Plus on augmente la richesse générée par les marchés financiers plus elle est accaparée par les investisseurs les plus riches, ce qui accroît leur contrôle sur l'économie réelle et sur la politique économique elle-même. Ce texte conclut en rejetant la taxe sur les transactions financières. Il plaide au contraire pour des politiques qui redistribuent le capital financier et qui permettent à tous de jouer un rôle dans ce grand jeu de la redistribution qui est l'essence des marchés des capitaux.
1. INTRODUCTION

It is becoming part of the conventional wisdom that financial markets have come to dominate the real sector of developed economies. Conventional wisdom likewise holds that the financial sector dominates the real sector to such an extent that it actually harms the real economy. This view gets expressed in various forms.

In one guise there is the argument that capitalist economies are becoming more and more like gambling casinos (Strange, 1986). As economic systems increasingly focus on distributing or redistributing the economic pie, less effort goes into expanding the pie itself. As a result, the economic pie stops growing. This adds further impetus to redistribution as a means of increasing one's standard of living and further prevents the pie from growing.

Another iteration of this theme notes that business firms have become interested in making money through financial manipulations rather than by producing and selling goods and services (Reich, 1983, Chapter 6). In addition, bright and talented individuals seek careers in finance and its rather than activities that produce goods and services. Again, productivity suffers and economies grow more slowly.

Finally, it is frequently claimed that financial markets constrain the use of economic policy. Any attempt to expand national economies by bringing unemployment down to the level of the 1960s or the 1970s, raises the specter of inflation. Capital markets begin to tremble, and policy makers are forced to switch gears. Things are even worse if fiscal policy is involved in trying to reduce unemployment rates. Then, in addition to fears of inflation, we have fears of large government budget deficits. Capital asset prices now fall for two reasons. When the hands of policy makers are tied because they are at the mercy of financial markets, the national economy must be left to sink or swim on its own. The too can lead to worse economic performance. Moreover, if economic performance is path dependent or hysteretic (Cress, 1993, Sutterfield, 1993, 1995), economies will suffer from long run stagnation if policies are not employed to improve short run outcomes.

The goal of this paper is to examine these fears and put forth some policy proposals for dealing with the problems created by capital markets. But this requires a correct understanding of how such markets fit into a modern capitalist economy. Only by understanding the role and function of capital markets can we distinguish between legitimate fears and false fears; and only by making this distinction can we develop viable policies to deal with problems that arise on the financial side of the economy.

The remainder of this paper is organized as follows. The next section presents the neoclassical view of capital markets, while section III looks at the flaws with this view. Sections IV and V then set forth a view of the actual role of capital markets in developed economies and the real negative consequences of these markets. Financial markets, it is argued, exist to redistribute wealth. Greater wealth in these markets has given them greater influence over economic policy makers, to the benefit of wealthy investors. This analysis leads us, in the final section of the paper, to set policy recommendations to better balance the claims of capital markets for financial gain with the claims of national citizens for economic growth and low unemployment.

II. THE NEOCLASSICAL VIEW OF CAPITAL MARKETS

According to neoclassical economic theory capital markets perform important functions. First, they are a bull that makes investment easy to undertake. Because of capital markets, assets are easily sold, Capital markets thus increase investment by providing liquidity to investors (Black and Hirt, 1988). They do this in two ways. First, they make it easy for corporations to raise funds for investment. Printing and selling new securities gives the firm an alternative to bank debt as a means of financing new investment. Second, they allow individuals to sell securities quickly. Households should therefore be more willing to lend money to firms because their money need not be tied up for many years. By providing a ready and easy way to sell investments, capital markets encourage the flow of money to corporations, and thus lead to greater investment in plants and equipment. With more money going from household savings to business investment we should see increased productivity growth and rising living standards.

A second function of capital markets is to allocate capital or investment funds. That is, they make sure that capital gets deployed in the best manner possible, supporting those investments that yield the highest possible rate of return for the economy. As such, capital markets contribute directly to productivity growth and to higher living standards.

Efficient markets theory provides the foundation for this second strand of the neoclassical view of capital markets. This theory is the financial equivalent of rational expectations macroeconomics. It holds that capital markets take all available information into account about the future profitability of a firm. These markets then use this information, and this information only, to determine the value of specific firms. The market valuation for each firm thus reflects its expected future profitability.
based upon all available information, and provides the best forecast of security's future return. Furthermore, all price changes reflect primarily new information about future dividends and future profitability of the firm.

This view of capital markets has one important policy implication. If financial markets are efficient, there is no justification for economic policies that attempt to control speculation in capital markets. Market prices reflect only available information about future profitability. Price changes reflect only new information regarding profitability; they cannot disrupt the real economy. **Laissez-faire should be the appropriate policy since the market automatically and efficiently disseminates all new information, leading to more and better investment decisions. Any political interference would worsen economic performance and outcomes, since it would shift investment to less profitable endeavors.**

Consider two firms, F1 and F2, each with the same price and each yielding the same return (dividends plus capital gains) to investors. Now suppose that one firm, F1, makes a new discovery. This increases expected future income flow. With higher expected returns, investors will buy shares of stock in F1 since it now yields a greater return than holding the stock of F2. This will increase the price of F1's stock and reduce the rate of return on holding this stock, since the stock now has a higher price. Conversely, sales of F2's stock will lower its price, and raise the expected rate of return given this new, lower price. The expected returns for each stock once again become equal. In the process, capital flows out of F2 and into F1, the firm that has made the new and profitable advance.

The neoclassical argument, based on efficient markets theory, thus supposes that future profitability attracts capital and that capital markets know the future profitability of each firm. Given these assumptions, the conclusion readily follows that free and unhampered capital markets will move capital to its most productive uses. Trading activity is likewise beneficial, for it too helps efficiently allocate capital.

### III. Problems with the Neoclassical View of Capital Markets

There are numerous and well-known problems with the neoclassical argument in favor of capital markets. It is important to note at the outset that most of these flaws are recognized by neoclassical orthodoxies. Mainstream economists, however, hold firm to their views of capital markets because they have no alternative theory to explain the operations of such markets. Blinded by their own theoretical perspective, they recognize examples as mere anomalies that need to be explained within an orthodox framework or explained away. However, the flaws with the mainstream view are so great and so pervasive that they cannot be explained away.

A first problem with the neoclassical view stems from its failure to distinguish new issues of stocks from the buying and selling of old stock issues. New stock issues are presumably for the purpose of raising funds to purchase new plants and equipment. This form of business investment would have the productivity-enhancing, or supply-side, impact that neoclassical economists point to when they argue for the importance of capital markets.

But buying and selling of existing shares of stock is another matter. In this case, there is always both a buyer and a seller; the buyer receives stock that represents existing capital, and the seller gets rid of shares that represent the same capital stock. While the buyer is investing from a microeconomic point of view (he is purchasing plants and equipment), the seller is disinvesting by an amount equal to the buying price (ignoring for now all transfer fees). From a macroeconomic perspective there is no new investment in plants and equipment. Likewise, there should be no improvements in productivity growth and living standards from such trading activity. Only the printing and selling of new stock can have these beneficial effects.

Moreover, most of the actual activity taking place on capital markets involves stock issues. For example, during 1992 new stock issues in the US totaled $388.3 billion; the market value of all stocks totaled $4.8 trillion (US Department of Commerce, 1995). New issues thus comprised less than two percent of existing shares. Looking at the value of stocks traded during the year, rather than value of all existing shares, makes new stock issues even less important. Capital markets are thus essentially large and glorified used car markets; yet we live in a world where new car production and new car markets are important.

At this point the neoclassical theorist is likely to respond that the used capital market encourages new stock offerings; that is, the used market positively affects the new market. If investors could not readily sell their shares they would not risk their money by giving it to firms for capital construction or expansion purposes. Active capital markets thus make it possible to raise more capital than would otherwise be the case.

This response, though, is inadequate for a number of reasons. First, business firms have three financing options once they have decided to undertake expansion - they can borrow money from banks (debt financing), they can print up pieces of paper and try to sell them in capital markets (equity financing), or they use their retained earnings to finance the new investment (self-financing). Even with rudimentary and poor
capital markets, firms could still go to banks and borrow money. They could also use internal funds to finance new capital construction. At best, the gains from capital markets are much smaller than the neoclassical view would have us suppose. Moreover, firms rely first and foremost on credit for expansion. Equity financing (stocks and bonds) represents only 30 percent of the external funds for new capital investment in the United States. Most of the rest of external financing comes from loans (Mayer, 1993, p. 312). The situation in other developed countries is not very different from that of the United States (Mishkin, 1992, p. 159). Furthermore, the argument that an active and developed capital market spurs growth is not altogether empirical inquiry. Greater trading activity in the United States during the 1980s did not lead to greater investment (see Table 1), as the neoclassical view predicts.

### Table 1

<table>
<thead>
<tr>
<th>Years</th>
<th>Market Value of NYSE Sales/GDP</th>
<th>Ratio of Investment to GDP</th>
<th>Productivity Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964-65</td>
<td>9.4%</td>
<td>14.8%</td>
<td>3.7%</td>
</tr>
<tr>
<td>1966-67</td>
<td>13.8%</td>
<td>15.9%</td>
<td>2.3%</td>
</tr>
<tr>
<td>1971-75</td>
<td>11.2%</td>
<td>15.7%</td>
<td>1.9%</td>
</tr>
<tr>
<td>1976-80</td>
<td>10.3%</td>
<td>16.2%</td>
<td>0.7%</td>
</tr>
<tr>
<td>1981-85</td>
<td>20.2%</td>
<td>15.9%</td>
<td>1.5%</td>
</tr>
<tr>
<td>1986-90</td>
<td>32.3%</td>
<td>15.9%</td>
<td>0.7%</td>
</tr>
</tbody>
</table>

Sources: Economic Report of the President (1992) and Statistical Abstract of the United States (various years).

Let us now examine the neoclassical claim that capital markets efficiently allocate capital resources. Theoretically, this argument leaves much to be desired. As Keynes (1936, p. 156f) noted, capital markets have a tendency to be like beauty contests, where judges look not for the face that they think is most beautiful, but rather for the one that they think other judges will see as the most beautiful, taking into account the fact that these judges too will have to figure out what the other judges will be thinking. Analogously, capital will go not to firms with prospects for the highest returns, but to those firms that average people think that other average people will do well.

But the main case again the view that capital markets can efficiently allocate capital is empirical. Many studies of capital markets have shown them to be anything but efficient. There is the well-known January Effect, whereby stock prices rise more and provide investors with greater returns in the month of January than in any other month. Similarly, there are Weekend Effects, where returns are higher on Fridays and lower on Mondays than on any other day of the week. According to the efficient market hypothesis this cannot be the case, since if January (or Friday) Effects existed investors would know about it and buy stocks in December (or on Thursdays). Stocks would then rise in December (or on Thursdays) simply because people bought shares in anticipation of the January (or Weekend) Effect. As a result, these time-dependent gains would get eliminated. Rational investors will always seek out gains that accrue at a specific time of the year according to efficient market theory, they and will eliminate any gains that they find, buying stocks in anticipation of such gains (Pearce, 1987).

Small Firms Effects constitute another counterexample to the efficient markets hypothesis. In efficient markets, higher returns on small stocks should be due entirely to the greater risk associated with such investments. But empirical evidence indicates that the higher return on small firm stocks is not due to their higher beta-coefficient (the usual measure of risk, defined as the ratio between the variability of the firm stock and the average variability of stock prices) (Pearce, 1987; Fortune, 1991).

Next, capital markets seem to be driven by speculation as much as they are driven by rationality. The work of Robert Schiller (1981, 1984) has shown that stock prices have been more volatile than the efficient markets hypothesis would predict. Given the sharp changes in stock prices over time, dividends have been remarkably stable. Looking at more than 100 years of data, Schiller (1981, p. 433f) concludes that stock price volatility is “five to thirteen times too high, to be attributed to future real dividends”. Even a hard core neoclassical as Arrow (1982) has concluded from this work that the stock market does not allocate capital efficiently.

Finally, efficient markets theory implies that investment advice based on publicly available information should be worthless, for such information should be incorporated into the value of assets. Yet, Value Line uses public information to rank stocks by their expected returns, and studies have found that following the advice of Value Line would have earned an investor abnormally high returns (see Pearce, 1987).

Another way to see that capital markets do not lead to the sort of outcomes hypothesized by neoclassical economists is to consider the relationships between stock market activity on the one hand, and business investment and productivity growth on the other. If the world works as neoclassical economists claim, then greater stock market
activity should increase business investment, and through more efficient capital allocation, improve productivity growth. Table 1 looks at these relationships for the United States economy over the 25-year period from 1951 to 1990. The table shows that there is little correlation between trading activity on the New York Stock Exchange and business investment. Even worse, the best measure of overall efficiency—the rate of productivity growth—turned in its poorest performance during the 1980s, when stock market activity was greatest. Empirical evidence indicates that capital markets are a rather inefficient means of allocating capital to its most productive uses.

Recognizing that capital markets cannot really allocate anything, adherents of the neoclassical perspective frequently fall back on the assertion that capital markets play an informational or signaling role. High stock prices tell managers that their firms should be investing more. Low stock prices tell managers that they should not be investing in new plants and equipment. This is one way that the knowledge possessed by investors can influence the people they hire to manage firms for them, and can thus improve firm performance.

But the informational argument in favor of capital markets is quite weak (See Stiglitz, 1989). Higher stock prices do not carry information about which investment projects to undertake; at best all they do is let the firm know that it should invest more. Thus capital markets may be able to allocate funds to firms, but it is the firm that allocates the funds to different investment projects. Capital markets cannot provide any help with this decision. Yet it is this decision that leads to the efficient allocation of capital and to the desired return on the investment. Thus, even if a higher stock price signals to the firm that it should expand, this signal is worthless.

IV. Why the Focus on Capital Markets?

If capital markets are not important because of their positive effects on investment, or because they help allocate capital efficiently, what explains our infatuation with capital markets? Why do central bankers concern themselves with what is happening on financial markets, and why do politicians tend to employ fiscal policies with one eye on public opinion polls and the other eye on national stock markets? These reasons suggest themselves. These reasons will lead us to a very different view of the functions performed by capital markets.

First, capital markets are important because of the sheer magnitude involved. Since so much national wealth and so much individual wealth resides in capital markets, it is only natural that attention will focus on their gyrations. According to the New York Stock Exchange Fact Book, in 1987 companies on the NYSE were worth close to $2.5 trillion and comprised over 80 percent of the value of all American stocks. All U.S. stocks would thus have a total value of around $3 trillion. In 1987 this amounted to around 75 percent of U.S. GDP and 100 percent of consumer spending. Thus a mere 1 percent change in the value of stocks in 1987 would have lead to $30 billion change in the income of American citizens assuming that all the stocks are owned either directly or indirectly by Americans. A twenty percent drop in stock prices, as occurred on Black Monday in October 1987, would be like a twenty percent wage reduction for American consumers.

Second, there probably exists a human tendency to be infatuated with wealth and to admire the affluent. Veblen (1899) pointed out long ago, and Galbraith (1958) more recently, the importance of invidious comparisons and conspicuous consumption as a driving force in the economy. As is well-known, the wealthy own most of the stock shares in the United States. "In 1983, 54 percent of the total net financial assets were held by the 2 percent of families with the greatest amount of such assets and 86 percent by the top 10 percent". (Survey, 1984; p. 863.) Given the penchant for the very wealthy to under-report their income and wealth, a survey of this sort, both the actual facts are certainly that wealth is even more concentrated than the Federal Reserve reports. But it is not just the general populace that admires wealth and focuses on how the rich are living; the affluent care very much about their own well-being. Since so much of their wealth is tied up in capital markets, the rich and powerful care very much about these markets; and they are likely to use their influence to protect their wealth.

This leads us to the reasons that politicians and central bankers express excessive concern about capital markets. Politicians want to get re-elected to office. In a world where ownership of stock is widely dispersed (even though concentrated in the hands of a very few) and many middle class households own shares either directly or indirectly through their pension funds, changes in stock prices impact the net worth of most families. As a rough index of the increase in stock ownership, consider the following figures from New York Stock Exchange (various years) surveys. In 1952, only 4 percent of the U.S. population owned shares on the New York Stock Exchange. This increased to 10 percent in 1959 and to 15 percent by 1970. Thereafter it remained a bit below 15 percent until the 1980s, when it increased to the 15 to 20 percent range.

With wider stock ownership, falling stock prices mean that many more families lose net worth. Politicians are likely to be held responsible
for this by the electorate whether or not it is their fait, and whether or not their policies contributed to the price decline. This means that fiscal policy must be made with greater concern about its impact on financial markets. If government budget deficits (other things being equal) increase interest rates, and if higher interest rates (other things being equal here too) reduce capital asset prices, then governments must be more careful about running large deficits when more citizens own stocks.

Surely, if we had no deficit and suffered high unemployment instead this too would have negative political ramifications. As Tufte (1978) has pointed out the likelihood of re-election for American politicians depends heavily on the rate of unemployment (thus explaining the political business cycle). The point here is not that unemployment has become irrelevant, but that the growth of capital markets has increased one pressure point that politicians must balance against all the others. Since this new force pushes hard for low inflation (since this tends to increase stock prices), less expansionary economic policies will be put into effect by government policy makers. In support of this point, Pressman (1993) demonstrates that since the 1970s policymakers in the G7 countries have been less likely to run deficits as an expansionary policy tool.

What is true of politicians is true of central bankers to an even greater degree. Much has been written recently about the importance of central bank independence for good economic performance, especially on the inflation front (Alesina, 1988; Alesina and Summers, 1993; Cukierman, 1992; Cukierman et al., 1992). A lot of this literature is circular, ultimately assuming what it wants to prove by defining central bank independence in terms of low inflation rates.

Despite the flaws in studies of central bank independence, an important point brought out by this work is that central bankers are indeed subject to pressures from the political arena. However, this is not the end of the story. As Greider (1987) and Galbraith (1993) have argued, central bankers are also subject to pressure from important actors in financial markets. Greider, in particular, has extensively documented how the financial community pressured the Federal Reserve to keep interest rates up and inflation down, during the late 1970s and early 1980s. This, in turn, contributed to the worst recession in the United States since the Great Depression.

Combining both the central bank independence literature and the arguments of Greider and Galbraith, one can think of central bankers as having to balance their own self-interests in light of two conflicting pressures. On the one hand, politicians will want central bankers to employ policies that maximize their chances of getting re-elected. Thus Senators may grill the Federal Reserve Chairman in public if the central bank policies threaten their re-election. On a Democratic President may threaten not to reappoint the head of the central bank when his term expires if he does not lower interest rates and increase his re-election prospects. Such a threat does not even have to be made explicitly; it can be made implicitly through choosing a sympathetic individual as Vice Chair and it making clear to the central bank Chairman that you are not happy with his policy making.

On the other hand, central bankers will also be subject to pressure from the financial community. Such pressure is also likely to be implicit rather than explicit. Anyone sitting on the governing board of a central bank makes relatively little money. However, when one gives up their position at the central bank, one will have the opportunity to make a great deal of money. This money of course, is likely come from the financial institutions one is presently regulating. As expected future monetary returns grow relative to current income, the pressures exerted by financial institutions increase on central bank members. Central bankers become less independent of the financial community and their policy decisions aim to please the financial community more and more.

Y. WHAT CAPITAL MARKETS DO, IN FACT, DO

We have seen that standard explanations for the efficacy of capital markets are based more on wishful thinking than on clear logical thinking. We have also seen that free capital markets do not have the actual benefits predicted by neoclassical theory. They do not help allocate capital more efficiently, they do not increase business investment in plants and equipment, and they do not contribute to greater productivity growth.

We have also seen why policy makers are so infiltrated with capital markets. It is in their self-interest to do so. Politicians who ignore capital values are not to get re-elected when stock ownership is widely dispersed. Also, when re-election depends upon raising money, and where most of the money raised comes from those with great wealth, politicians must be concerned with the wealth of their financial contributors. Likewise, central bankers are concerned not to alienate a financial community that has the power to enrich them when they step down from the higher altitudes of the regulatory business.

Throughout our analysis of capital markets we have seen again and again the one important function of capital markets — they redistribute
wealth in an economy. Capital markets redistribute wealth in three different ways.

First, the returns available in capital markets have, over long periods of time, exceeded the returns available through other sources. As a result, people who put money into capital markets earn a larger return than would be possible through other means. It is well known that, due to compounding, a few extra percentage points can make a huge difference in the amount of wealth accumulated many years in the future. Over several generations, the high returns available in capital markets have helped to concentrate wealth in the hands of a small group of people. As such, capital markets function to redistribute wealth to people with money who are willing to take some additional risks to make even more money. This is why the affluent have their assets in financial markets and also why "affluent wannabes" are including more capital assets in their portfolios.

This brings us to the second way capital markets redistribute wealth: On a regular basis some stocks increase in price while other stocks decline. These changes in value can be considerable, although they will not be entirely predictable. An investor who has guessed smartly or guessed well can double his or her money in a few years. In contrast, an investor who has guessed poorly can lose significant parts of his or her wealth. As Keynes (1933, p. 109) said: "A speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware." Capital markets thus provide an opportunity for gambling with better odds than state lotteries or gambling casinos because there are no or few total losers, and because the expected value of gambling on stock exchanges is positive rather than negative.

Finally, capital markets redistribute income from physical investment in plants and equipment to financial institutions. Summers and Summers (1989, p. 121) estimate that "the cost of operating our securities market was over $75 billion in 1987. This represented one-fourth of total corporate profits, and close to half of corporate net investment." Contrary to the neoclassical position that capital markets help increase investment, capital markets absorb resources which could have been put towards economic expansion.

In sum, capital markets play the role that war and plunder played in earlier times. They allow a few individuals, through some part luck and some part shrewd insights, to become very rich. But, as with war and plunder, the costs to all of society can be considerable when a few people get enriched at the expense of everyone else.

VI. POLICY IMPLICATIONS

What are the policy implications of this view of capital markets? A number of people (Robbin, 1984; Stulz, 1989; Summers & Summers, 1989) have argued for a transactions tax on all stock purchases and sales. Following the line of Keynes, these economists see speculation as dominating production in the United States economy, and they look toward taxation as a way to throw some sand in the wheels of capital markets. Their hope is that by reducing speculative activity on stock exchanges, these markets will work more efficiently.

Developing this idea even further, some economists have argued that tax rates should be a function of the length of time that people have held the capital asset. Assets held for long periods of time (say 5 years) would not be subject to any transactions tax. Assets held for 2 to 5 years would be taxed at very low rate, assets held for 1 to 2 years would be taxed at higher rate, and assets held for less than a year would be subject to the highest transactions tax rate.

Besides generating substantial revenue for the central government (a 5% tax on every stock transaction would raise more than $10 billion according to Summers & Summers 1989), advocates of such a tax believe that it would reduce speculative noise in capital markets. The activity that remains would lead to a better distribution of capital, and so contribute to a better performing economy.

The problem is that this policy proposal follows from the neoclassical belief that capital markets exist to efficiently allocate capital. Transfer taxes increase the costs of speculation and thereby reduce speculative trading.

But as we have seen capital markets do not, cannot, and are not supposed to, efficiently allocate capital. Rather, capital markets exist to redistribute wealth. Consequently, transfer taxes cannot help improve the allocation of physical investments and cannot be used to help improve productivity growth. Moreover, if capital markets exist to redistribute wealth rather than efficiently allocate investment, a transfer tax may not affect this process very much, just as taxes on lottery winnings and gambling earnings have not reduced the willingness of people to engage in these forms of wealth redistribution. An empirical study comparing transfer taxes and stock market volatility across 23 different countries provides some support for this view. Roll (1989) found that higher transactions taxes is somewhat correlated with greater capital market volatility; however, these correlations are not statistically significant.

Moreover, if there is some human proclivity to gambling, by reducing the ability to gamble in capital markets we may encourage similar
activities in other, less-desirable areas (fraud, etc.). To paraphrase Keynes, it may be better that people tyrannize over their stock holdings rather than over each other.

Another way to make this last point is to note that transfer taxes operate on the wrong side of the market. Friedman (1960) has pointed out that they must be distinct and discernible psychological gains to those who engage in speculative activity. Clearly, people value gambling and are willing to pay a price to gamble, since gambling activities lead to an expected economic loss. People are willing to spend a great deal of time travelling to gambling casinos and waiting on line to buy lottery tickets, despite the fact that the chances of getting killed while waiting on line exceed the chances of winning the lottery. One can also view the costs of operating a national financial system as part of the price of gambling. And the cost here, as we have seen, are rather astounding.

If this game of redistributing wealth is, as Friedman argues, something that we desire, then the right solution is not to discourage such activity. Nor should we increase the costs of such activity so that only the wealthy can engage in it. Rather, we must keep the costs down and make sure that everyone has the opportunity to participate. The solution is thus not to throw sand into the wheels of capital markets, but to give everyone the opportunity to gain from the grand redistributive game. This could be accomplished in several different ways.

Sheraden (1991) has proposed a scheme where the government would provide unemployed and poor families with capital accounts in addition to income support. These Individual Development Accounts would be like Individual Retirement Accounts, except that withdrawals would be permitted for individual human capital accumulation (education and training) and for a down payment on a home. Similarly, Haveman (1988) has proposed that the government give a $20,000 capital account to every American child. The money in this account could be used for approved expenditures on education, training, and health care. Going one step further, why not let individuals take their Individual Development Accounts or their capital accounts and invest the money in capital markets?

In a broader vein, Kelso and Stagner (1958) have proposed requiring businesses to institute stock ownership plans for all their employees. Such plans have been found to increase productivity (Conte and Svejnar, 1990). They would also allow more people to take advantage of the greater returns that are available in capital markets.

As a second reform, we must make sure that financiers do not gain excessively at the expense of investors and at the expense investment in plants and equipment. It is hard to fathom any benefit from stock exchanges that absorb one-quarter of corporate profits and one-half of the national investment.

Traditionally, there have been two ways to control the supply side of the economy -- induce more competition and control prices. With greater competition, transaction costs fall as firms enter the market seeking a share of the monopolistic profits. With price controls, the government accepts a non-competitive situation, but reduces the cost to citizens who must patronize large firms. Both approaches would reduce the ability of the financial sector to extract exorbitant rents from the real sector of the economy.

Either approach will surely encounter great opposition from the financial community, for they entail large declines in the profits, the power, and the prestige of the financial sector. While the social reformer has no reason to consider the interest expressed by financial institutions important, the political reformer would have to educate them to the need for greater competition. In practice, to break the economic power of the financial community, it is necessary to use those principles that are deeply-held by the financial community itself. It is relatively simple to impose government regulations on the market, and the financial community would certainly have an easy time defending any government regulation of the fees charged by investment banks and brokerage firms. But it would be more difficult for the political community to support a policy that promotes competition in financial markets by allowing easier entry into these markets.

Reducing the economic power of the financial community through greater competition will likewise entail a loss of their political clout, since that clout exists primarily because it is purchased with the money obtained from excessive profits. As a result, both politicians and central bankers will be less pressured to control inflation through restrictive fiscal and monetary policies. This too should help democratize economic policy making and thereby improve overall economic performance.

References


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