

# Stanford SOCIAL INNOVATION<sup>Review</sup>

---

***Realizing Democracy Supplement***  
**Other People's Money**  
By Anat R. Admati

Stanford Social Innovation Review  
Winter 2020

Copyright © 2019 by Leland Stanford Jr. University  
All Rights Reserved

*Stanford Social Innovation Review*  
[www.ssir.org](http://www.ssir.org)  
Email: [editor@ssir.org](mailto:editor@ssir.org)

relevant unions, and how to expand their base by building solidarity with students, parents, and the broader community. It happened fast, and the results are a model for exactly what needs to happen nationwide. These victories required power, not merely “a voice.”

Good strikes force the very consensus building that America needs, and the sooner we reprioritize unions, the sooner we can reclaim democracy. ●

## Other People's Money

Better education about the role of effective governance ensures that markets and institutions serve society.

BY ANAT R. ADMATI

**T**he debates about our economic system are sometimes framed as a stark choice between market-based capitalism and government-controlled socialism. But the actual choices are much more complicated. Corporations, which control much of our economic activity today, owe their existence to governments. Although they do not vote in elections, the economic and political power of corporations and their impact on democracy are immense. The challenge arises from the tension between functioning democracy on one hand and narrowly defined business practices on the other hand. For the market economy to serve society in a democracy, more citizens must become educated about the forces that shape the system, including corporations and governments, and the key role of effective governance in determining the outcomes.

In his famous 1970 essay “The Social Responsibility of Business Is to Increase its Profits,” Milton Friedman championed “free-market capitalism” where managers should “make as much money as possible while conforming to the rules of society.” He presumed

that businesses operate in an environment of “open and free competition without deception and fraud,” but he failed to discuss whether or under what conditions this assumption is true. In fact, markets are unlikely to become competitive and devoid of deception and fraud on their own, and capitalism cannot deliver on its promise without effective governments.

Friedman warned against “the iron fist of government bureaucrats” that the concerns of chief executives about corporate social responsibility would bring back. But a key role of government is to enable markets and to protect stakeholders when market forces fail to do so properly. The civil servants (“bureaucrats”) who Friedman mentioned derisively are essential for enforcing contracts, ensuring competition, administering justice, protecting rights, and dealing with fraud and deception when conventions, accepted business practices, or cultural norms fail to hold actors accountable to socially acceptable behavior. Governments also maintain infrastructure and provide important services, including public safety, benefits that many ignore or take for granted. If governments fail to design and enforce appropriate laws for individuals, businesses and markets, then it no longer follows that managers who solely focus on making as much money as possible are fulfilling their social responsibility.

The critical issues lie not in the size of government, but rather in the quality, integrity, and effectiveness of the individuals and institutions that act on its behalf. To fully realize the benefits of democracy, political systems and government institutions must embody the collective choices of all citizens, and the rules of the game must be designed and enforced to serve the social good.

These days, well-functioning democracies are few and far between. Democracy itself appears to be in retreat around the world, and trust in private and government institutions, particularly in the United States, is low. In a 2018 poll conducted by Harvard University's Institute of Politics, nearly two-thirds of Americans ages 18–29 expressed fear for the future of democracy in America, and in a 2018 Gallup Poll, only 25 percent of Americans expressed “a lot” or “a great deal” of confidence in big business. Public trust in the US government seems to be at a near historical low. Unfocused anger with “the system” can be misdirected by demagogues and lead us away from the right solutions. To

tackle effectively the lack of trust and the distortions in our prevailing economic system and in our democracy, we must first diagnose their underlying causes.

The problems plaguing democracy and capitalism are largely rooted in the complex interactions between corporations, governments, and individuals. These interactions are fraught with conflicts of interest, wide gaps in information and expertise, and the potential for abuse of power. Effective governance is key. How do we ensure transparency to hold the powerful accountable in the private and public sectors? How do we prevent conflicted experts and narrow interests from having excessive impact, particularly on issues that appear complex and confusing to nonexperts and the public? Ultimately, how can we trust those with power in corporations and in government institutions who have important impact over our lives to avoid abusing their power and causing harm?

Corporations and governments have numerous points of contact. Some interactions are primarily transactional: when corporations sell goods and services to government bodies, including essential services such as prisons, security forces, transportation, weapons, health care and medicines, for example. Some corporations act as private watchdogs, providing credit ratings and financial audits to private and

### Particularly insidious challenges to democracy arise when corporations become involved in the writing of the rules that apply to everyone, including themselves.

government entities. Financial institutions are involved in funding governments as investors and intermediaries. Consultants offer advice to governments as well as to corporations. Media corporations inform the public about government bodies as well as on private sector corporations. In all these engagements, conflicts of interests and information gaps create numerous opportunities for abuse of entrusted power. Corruption can occur even if nobody breaks laws.

Particularly insidious challenges to democracy arise when corporations become involved in the writing of the rules that apply to everyone, including themselves, or interfere with

ANAT R. ADMATI is the George G.C. Parker professor of finance and economics and faculty director of the Corporations and Society Initiative at Stanford Graduate School of Business. She is an economist with broad interests in the interactions between business, law, and policy.

enforcement. The problem is not new, but it has been exacerbated with increases in corporate lobbying activity. Over their history, US corporations have used the legal system to gain many legal rights and fight against government rules. Some of the legal rights of corporations are important to their ability to benefit society; others, however, such as political speech and religious rights, aren't directly linked to any social benefits. Yet, the 2010 decision by the US Supreme Court in the case *Citizens United v. Federal Election Commission* allows corporations to spend unlimited amounts of money on campaign contributions and political activity.

When corporate engagement with governments serves narrow interests and money is critical for campaigns and influence, the system causes "corruptive dependencies," exacerbates inequality, and leads to the perception that our "captured economy" is rigged and unjust. Corporations can also pit governments in different jurisdictions against each other, leading governments to offer them privileges that may not benefit the public, or to weaken useful rules so as to help some corporations succeed even at the cost of harming citizens. Examples of corporations undermining democracy through policy engagement are rampant in the financial sector and in the pharmaceutical, coal, and gun industries.

I first encountered these issues when looking at the banking sector after the financial crisis of 2007-2009, which led me to realize that many of the assumptions about markets and corporations that are routinely made in research and teaching about financial markets and corporations are false. The crisis was not, as some conveniently imply, akin to an unpreventable natural disaster; rather, it was the result of failed corporate governance and poorly designed and ineffective rules that tolerated waste, fraud, and an enormous buildup of unnecessary risk. The rules effectively rewarded recklessness and exacerbated the fragility of the system.

In *Crashed: How a Decade of Financial Crises Changed the World*, Adam Tooze describes how developments before 2007 and since, including the extraordinary actions by governments and central banks and the narratives and public anger surrounding the events, exposed the enormous harm that free-market capitalism and government failures can cause. The crisis transformed our economic, political and geopolitical landscape in ways that continue to have substantial impact on us today.

Over the last decade, I have engaged with trying to improve the rules for the financial

system, and I witnessed with dismay and concern how distorted incentives, averted eyes, and insufficient accountability have led markets and governments to fail society. The reformed rules after the financial crisis do not reflect the full lessons of the crisis and maintain a largely unchanged system that is inefficient, reckless, and opaque. Some rules are too costly and counterproductive, while others are unnecessarily complex, yet weak and inadequate, benefiting few and harming and endangering the rest unnecessarily.

In "It Takes a Village to Maintain a Dangerous Financial System," I discuss the actions and motivations of the numerous enablers in the private sector, government, and even academia that are collectively responsible for this situation. These enablers remain unaccountable because the issues appear complex and confus-

## **It is important to place governments in a better position to design and enforce proper rules ... and citizens in a better position to hold all those in power accountable.**

ing to the public. Flawed claims contribute to the confusion, muddle the debate, and continue to impact policy and cause harm. Creating a better financial system requires that citizens become savvier as consumers of the system and better informed about its flaws and what can be done to correct them. Teaching at universities can help, but much more is needed to challenge the entrenched system.

Similar problems arise in many policy areas in which experts might be conflicted and where the harm, or specific flaws in corporate governance and policy, are difficult for nonexperts to detect or know how to correct. Examples include financial disclosures, technology, and the environment. The recent scandal involving Boeing and the Federal Aviation Administration shows that even in aviation safety, distorted incentives in the private and public sectors can cause preventable harm. Other recent examples where corporations or government bodies caused or tolerated harm that their employees and leaders could have prevented but failed to do so are Purdue Pharma, Equifax, Theranos, Facebook, and Wells Fargo. Even when investigations reveal some of the culprits of harm, the typical outcome of excessive endangerment

and misconduct by corporation is a fine paid by shareholders and minimal if any consequences for leaders, raising questions about the justice system in a corporate context.

So far, those in the business community and business schools concerned with the loss of trust in capitalism or with problems such as climate change and inequality have focused on private-sector solutions involving philanthropy, social entrepreneurship, and impact investment. Perhaps in response to backlash against their focus on "shareholder value," 181 chief executives in the United States recently vowed, without being specific about how their practices might change, to consider all stakeholders.

Voluntary actions by the private sector can be useful, but they cannot solve society's big problems or replace governments altogether. Worse, the focus on private-sector solutions per-

petuates the flaw in Friedman's analysis by ignoring the critical role that governments must play and distracting us away from ensuring that governments act properly in our collective interests. By assuming that governments are unable or unwilling to solve social problems, those who focus on private-sector solutions fail to ask why governments

might be dysfunctional or to reflect on or take responsibility for their own role in causing harm or weakening governments.

Indeed, those who practice free-market capitalism today and count on governments to protect their property rights and safety may cause harm and undermine governments and democracy in their pursuit of profit. For example, to achieve success, managers may seek outsize subsidies and tax breaks and lobby to weaken beneficial safety standards or environmental regulations. They may also find it useful to confuse policymakers and the public so as to maintain market power or get away with reckless practices. Even if these actions do not violate the letter of existing laws, they may contradict the spirit of the laws and hinder their enforcement. And self-regulation is unlikely to suffice when stock-based compensation and pressure from aggressive investors create strong incentives to respond to the standard success metrics.

We can do more to tackle the governance problems at the nexus of corporations and democracy and improve the system. To root out subtle and often invisible forms of corruption and to ensure that markets, corporations, and

governments serve society, it is important to place governments in a better position to design and enforce proper rules, including for markets and corporations, and citizens in a better position to hold all those in power accountable.

To be effective, government bodies need appropriate resources, unconflicted expertise, and capable civil servants who are not prone to being corrupted. Well-designed rules can correct distortions, protect the public, and help markets work better, but poorly designed rules can exacerbate distortions. The details may be complex, but at least some citizens should be able to evaluate the rules and they should help citizens to hold those who write and enforce the rules properly accountable. Academic institutions and independent media can play important roles by providing unconflicted expertise as well as exposing governance and policy failures. And it is imperative that more people see through flawed and misleading claims that can scare or confuse politicians and voters to benefit narrow interests. Such strategies must not win.

Education is key to achieving these goals. Business schools, in particular, should work to eliminate some of the information asymmetries that lead to flawed rules, deception schemes, and lack of accountability. More generally, higher education programs should practice and promote civic-minded leadership and emphasize the importance of good governance mechanisms. As I have proposed in a recent piece at *Harvard Business Review*, doing so involves nuanced discussions of policy challenges related to business and society, collaborations to break disciplinary silos, and broader engagement across identity groups to elevate the level of public discourse beyond ideology and anger. A better informed and engaged citizenry can push, among other things, for badly needed reforms to campaign finance laws, improved transparency for corporations, and policies to improve governance and accountability in all institutions.

We face significant challenge in ensuring that our institutions are trustworthy. But we must first look beyond simplistic and misleading narratives about our choices. We do not have to choose between capitalism and socialism or between markets and big government. Rather, we must work to create a system in which corporations can thrive without distorting the economy and democracy, and in which governments write and enforce proper rules for all. Better education on the issues would be a good start. It is up to all of us. ●

# Against Nostalgia

Three takeaways to establish the structural and institutional guardrails necessary to achieving the democracy we need and deserve.

BY LISA GARCÍA BEDOLLA

**T**he articles in this supplement outline the changes that need to happen within civil society, government, and the economy in order for our society to realize its full democratic promise, arguably, for the first time.

The articles' authors propose and explain the key principles needed in order to establish those guardrails. The goal is to provide a holistic diagnosis of the problem—one that does not romanticize history but instead learns critical lessons from it. The stories from the field are meant to exemplify the courageous transformation that is already happening across the country.

**Building People Power** | The stories from Faith in Minnesota and the Los Angeles teachers strike make it clear that transformative changes are possible when organizations foster a sense of belonging and power within their communities. That sense grows out of relationships, the core of which are the authentic conversations that organizers have with their community members. For these transformations to be real, the knowledge community members bring must be valued rather than relying on the opinions of highly paid political consultants who are parachuted in for a campaign but have no connection to the community, no understanding of its context, and no sense of its history. Real changes must be grounded in all three, with relationship-building at the core. Realizing democracy requires bridge crossing within and across communities in order to ensure that the people can serve as a countervailing force that holds state and economic actors accountable.

**Reversing Institutional Capture** | A government cannot be seen as democratic if it is not accountable to its people. America's founders believed that state and local government were less dangerous than the federal government because they were closer to, and therefore more accountable to, the people. Hertel-Fernandez and Smith's

analysis suggests the Founders may have been wrong, showing how state governments have, for a variety of reasons, been captured by "the political interests of the well-organized, wealthy few at the expense of the broader public." Yet Hatch and Gerstein make clear that state and local government can also be seen as potential sites of democratic opportunity, as is evident in their success electing progressive prosecutors and working with attorneys general in localities across the country.

Their story shows what happens when attorneys general and district attorneys take a "broader view of what it means to represent The People." Their success suggests that when it comes to governmental transformation the collective imagination needs to be bigger. Changing the institutions themselves in fundamental ways in addition to changing the people within those institutions can turn incremental policy tweaks into transformative policy change.

**Building a Democratic Economy** | Democracy must value people over profits. Basic assumptions about markets, their value, and their efficiencies, need to shift. One of the most important changes that needs to happen is the acceptance of government as a countervailing force that is necessary and whose job it is to regulate markets in order to ensure that they serve the public good. The good news is that our current levels of economic inequality are the product of policy choices made over the past four decades. That means that those changes can be undone and government power can be used to check market power and ensure a more equitable distribution of economic resources. In order for this change to happen, the meaning of the economy must be broadened to include the workplace as a site of democracy and democratic practice.

Previous reform efforts have attempted to focus on one part of the problem—be it voting, government reform, or workplace issues. These essays make clear that all these factors are important and interrelated. American democracy has never been fully realized—for most of the nation's history, the majority of the US population was excluded from the franchise and alienated from their basic rights. The current democratic crisis has its roots in, among other things, resistance to the attempts by social movements, such as the civil rights movement, to demand access and fairness within our democratic institutions. Within that context, incremental reforms that tweak at the margins will not work. Without a serious, concerted, and holistic effort to address issues of power and inequality across civil society, government, and the economy, our democracy will never be fully realized. ●

LISA GARCÍA BEDOLLA is cofounder of the Center on Democracy and Organizing and vice provost for Graduate Studies and dean of the Graduate Division at UC Berkeley.