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Rewards for the Rich, Rhetoric for the Poor? Financial Governance Mechanisms in the U.S.

Helene Schuberth and Martin Schürz

1. Introduction

Paradoxes of capitalism is a notion grounded in the research program of critical theory (Honneth 2003). An institutional paradox in capitalism is a kind of ambiguity where something improves from a normative point of view but at the same time brings about a deterioration. For instance, institutional developments may strengthen emancipation and efficiency but also increase social control and containment. This strand of social science research stems from the Marxist tradition. However, it has given up the Marxian term of contradiction as the normative connotations of Marxist theory have not been fulfilled and as its orientation on the sphere of production – where contradictions and crises should have emerged – has neglected other relevant spheres of society.

Different models of capitalism have emerged and the divergences reflect differences in institutional structures, economic specialization and political coalitions (Boyer 1997, Kitschelt et al. 1999, Coates 2002). In the comparative political economy literature, the Varieties of Capitalism (VOC) approach recently received increased attention. It focuses on cross-national institutional differences and claims that various institutional features tightly interact (Hall and Soskice 2001). A key question researchers want to answer is what type of capitalism will prevail? Numerous typologies of capitalism have been provided, typically in the form of dichotomies: A *liberal capitalism* is distinguished from *non-liberal capitalism* (Streeck and Yamamura 2001), the *shareholder model* associated with the UK and the U.S. is confronted with the *stakeholder model* of Germany (Shinn 2001), and *managed capitalism* with *market capitalism* (Lütz 2000). VOC also characterizes two variants of capitalism: coordinated market economies (CMEs) and liberal market economies (LMEs). CMEs have the following characteristics: a long-term orientation in investment financing, centralized wage bargaining and cooperative industrial relations as well as cooperation of firms in education and training. Examples are Germany, Austria, and Finland. Rules are less important because reputation resulting from long-

term relationships is the coordinating device. The financing mode is relationship-based. It grants the financier some form of power over the firm being financed. It has higher entry costs and shows a lack of transparency, it is self-governing and relies on the importance of reputation. Banks play a dominant role and there are restrictions on competition. LMEs rely on short-term financing via financial markets and decentralized wage bargaining. Ownership is fragmented and corporate control is exercised via market mechanisms and is oriented towards shareholder value. Relations between economic agents are coordinated primarily by markets. The rules – insider trading restrictions, disclosure – serve to protect the interest of outside shareholders. *Arm's length financing* provides for a wide circle of lenders to the firm. The financier is mainly protected by contracts and courts, as enforcers of contracts are important.

Within the VOC literature, financial structure characteristics play a crucial role. They determine the corporate governance modes. Strong insider control by stakeholders, which is typically associated with bank financing, supports CMEs while strong corporate control by outside shareholders corresponds with LME characteristics. As argued by Hall and Soskice (2001), the issue of convergence towards the LME model crucially hinges on whether the ongoing liberalization of financial markets will eradicate any of the institutional subsystems of CMEs. VOC takes corporate governance literature as a reference and relies on a principal-agent model description of financial system reality. The problems noticed from this perspective are collective action problems: In LMEs, with fragmented ownership, no one has a serious interest in monitoring what the agents do. The fragmented shareholders are dependent on information provided by delegated monitors, so-called reputational intermediaries such as accountants, lawyers, bond rating agencies and banks. These intermediaries monitor business behavior and provide information on which investors can make decisions (Gourevitch 2002b, Aguilera and Jackson 2002).

VOC studies complementarities between formal institutions (subsystems) of economies. Even if these complementarities are essential, it is not clear, however, whether the subsystems themselves can be regarded as coherent entities. Lack of institutional coherence within one subsystem has important consequences for our understanding of dynamics of change. For this reason, as a case study we investigate whether formal and informal governance modes within the U.S. financial system are coherent. Hence, we extend the narrative of institutional complementarity between the subsystems, which involves assuming convergence of interests of different societal groups, by pointing towards incoherencies within one of the subsystem studied in VOC, namely the U.S. financial system: We change the typical unit of analysis in VOC – firms – and investigate the relationship of different income groups in the U.S. – the highest and the lowest percentiles – with the financial system. The literature on comparative capitalism operates on a too highly aggregated level and misses

conceptual inconsistencies. Focusing on the behavior of individuals has the advantage of shifting the perspective to real world phenomena and allows to question overly abstract models. We find substantial differences between governance modes related to the rich and the poor: The rich are incited to maximize individual revenues but, at the same time, subject to moral suasion *against* exercising such behavior, while the poor receive financial education to learn maximizing revenues and a discourse of egoistic values.

This study is presented in four sections. Section 2 discusses different concepts of institutions and critically evaluates rational choice institutionalism, an important prerequisite of the narrative of institutional complementarity. Next, the main features of the governance mechanisms of the U.S. financial system for CEOs and the poor are outlined (Section 3). The fourth section discusses the paradoxes of their main financial governance mechanisms, pecuniary incentives and information. Section 5 argues that a high degree of acceptance of inequality may account for the fact that paradoxes persist.

2. Preconditions of Institutional Complementarities

The two dominant strands of current institutionalist theorizing are "*rational choice institutionalism*" and "*sociological institutionalism*" (Scharpf 2000).

Rational choice institutionalism conceptualizes institutions as solutions to collective action problems. Actors follow their interests when they engage in strategic interaction with others. Incentives are defined by reference to the self-interest of actors whose preferences are mostly fixed. One of the core arguments of strategic interaction theory is that regardless of the actors' specific preferences, they will face cooperation problems in many respects, as there are incentives to behave in a time-inconsistent way. Thus, situations of strategic interaction give rise to benefits from cooperation. In theory and reality there is a great variety of possible game constellations (Franzese, Mooslechner and Schürz 2003). *Rational choice institutionalism considers i*nstitutions as a means by which diverse preferences of individuals are aggregated into choices for the collective. The context in which these interactions are embedded and the role of trust for institutional arrangements are neglected. The usual critical complaint about rational choice approaches is that institutions become simply a response to cost-benefit considerations and that factors such as history and ideology are denied. Particularly, a sensitivity to the social context of institutional interactions and the social bonds that exist among actors is missing. Pure reference to the social gains from coordination cannot explain why a particular setting of coordination is chosen. Different national experiences reveal the explanatory limitations of the rational choice approach, as institutional incentives fail to

explain the existing empirical differences.

Sociological institutionalism focuses on the institutionalized "*norms of appropriateness*" (March and Olson, 1989) and emphasizes the social nature of institutions by stressing their role in defining individual preferences. Institutions are defined in a broad sense, including elements like rules, incentives, routines, socially constructed views and shared beliefs. Institutions will determine not only what actors can do, but also their perceptions and thus what they will want to do. Institutional rules influence subsequent behavior not just in terms of strategies, but by modifying the aims actors wish to pursue and the way actors perceive themselves. Behavior may be shaped by goals, alternatives, and rules of maximization. But it may also be shaped by roles and norms that define standards of appropriateness.

The research strategy that claims complementarities between institutional features in different domains implicitly refers to rational choice institutionalism. The models of capitalism are seen as systems of mutually supportive economic and political institutions where complementarity is a precondition for economic success (Hall and Soskice 2001). Institutional complementarities make it advantageous to develop similar forms of coordination across spheres (Hall and Gingerich 2002). Herewith institutions and their complementarity are explained by their economic functions. Each type of capitalism represents a unique institutional equilibrium. But, as Streeck (1997) has underlined, institutions do in general not fit with each other because they were designed for that reason. To explain the existence of a particular institution by reference to the functions it serves for other institutions or for society as a whole is problematic. While it is quite easy to argue ex-post why a particular institution is functional it is far more difficult to do so ex ante. And even if institutions fit with each other in theory, actors might be unaware of the complementarity of a specific reform measure proposed.

In the comparative political economy literature a rather eclectic combination of theoretical building blocks taken from finance, corporate law and institutional economics can be found. As it is not conceivable just to combine different strands of literature, consider different methodologies and theoretical approaches in order to get a picture of all the determinants influencing financial systems, we will follow an alternative theoretical approach. Paradoxes of capitalism is the conceptual basis of the research program of the critical theory to explain structural transformations in contemporary societies (Honneth 2003). A paradox in capitalism is a kind of ambiguity where something gets better from a normative point of view, as e.g. the scope of individual freedom increases with the deregulation of markets, while the advantages of normative progress are associated with new forms of impoverishment and exclusion. Institutional paradoxes do not fit in rational choice explanations and are close to sociological institutionalism. In the following section we examine two characteristics of

LMEs as identified by VOC proponents – the monitoring function of capital markets and information acquisition. We do that by comparing their implementation in different social contexts. When studying the financial and corporate governance mechanisms in the U.S. we find paradoxical phenomena reaching from efficiency increasing incentives to misguiding behavior, from ethical norms to legitimizing facades, from individual autonomy to social exclusions.

3. Financial Governance Mechanisms for the Rich and the Poor

Financial governance refers to the creation (rule-setting) and exercise (rule-implementation) of authority of actors in the financial system where non-state actors play a decisive role. Formal (e.g. regulations) and informal modes of financial governance (e.g. values, trust) are exercised vis-à-vis a broad range of actors in society, far beyond financial market participants. The steering modes are primarily employed through the setting of positive incentives and negative sanctions. The monitoring function of capital markets and the crucial role of information dissemination are considered the main characteristics of financial systems in LMEs. We examine how the respective governance mechanisms that are associated with those two characteristics are exercised vis à vis the rich and the poor. Before doing so, we give a brief overview of distribution in stock ownership and the impact of CEO compensation on the development of distribution of earnings.

In the U.S., stock ownership has become more widespread at all income levels and increased to 51.9% by about 20% between 1989 and 2001 for all families (see Table 1). However, when considering the percentage of stock owned directly and indirectly by the poor, stock ownership has not become democratized. About 60% of households earn less than USD 50,000 per year and own less than 10% of stocks. About 30% of households earn less than USD 25,000 per year and own less than 2% of stocks.

Overall, empirical data do not show the emergence of an investor society but rather a persisting phenomenon of abstinence and/or exclusion of the poor. The financial attitudes of the poor differ from the ones of the rich. While the utilization of the financial system by the rich is high, the poor have a shorter financial planning horizon, they spend more rather than less of their incomes, they do not save regularly and are less willing and/or less able to take financial risks when saving.

Table 1: Concentration of Stock Ownership in the U.S. by Income Class in 2001

Income level	Share of households	Percent of households owning stock worth more than USD 9,999	Percent of stock owned
USD 250,000 or more	2.8	90.1	42.0
USD 100,000 – 249,999	11.8	78.8	28.5
USD 75,000 – 99,999	9.2	64.7	9.1
USD 50,000 – 74,999	17.4	47.0	10.9
USD 25,000 – 49,999	27.0	26.8	7.5
USD 15,000 – 24,999	15.0	10.5	1.1
Under USD 15,000	16.8	4.5	0.8
All	100	35.5	100

Source: Own calculations based on Federal Reserve Board 2001; includes direct ownership of stock shares and indirect ownership through mutual funds, trust and retirement accounts.

Table 2: Stock Holdings of Different Income Percentiles

	Families having stock holdings, direct and indirect		Median value among families with holdings (thousands of USD)	
Percentile of income	1992	2001	1992	2001
Less than 20	7.3	12.4	9.9	7.0
20 – 39,9	20.2	33.5	4.9	7.5
40 – 59,9	33.6	52.1	6.2	15.0
60 – 79,9	51.1	75.7	10.1	28.5
80 – 89,9	65.7	82.0	17.3	64.6
90 – 100	77.0	89.6	58.8	247.7

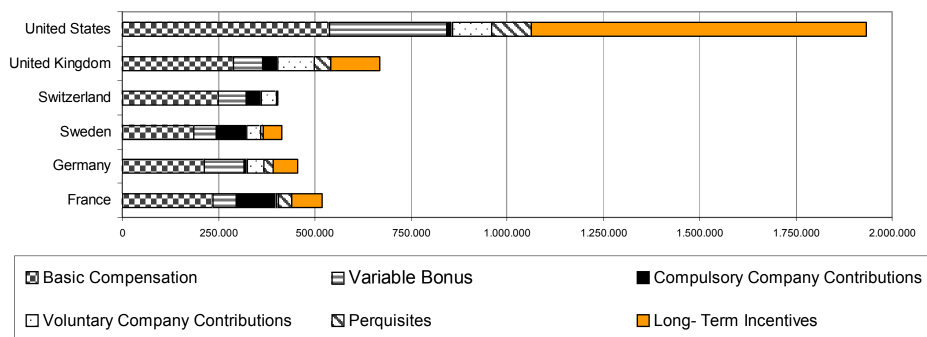
Source: Federal Reserve Board 2001, indirect holdings: mutual funds, retirement accounts and other managed assets.

Another phenomenon indirectly linked to financial governance is the large increase in inequality in wage earnings: The increase in top incomes in the U.S. has been spectacular compared to European countries. In the late 1970s, the richest 1% in the U.S. earned about 8% of the national income. By the end of the 1990s, as much as 14.6% of total U.S. incomes were concentrated in the hands of the top 1% (Piketty and Saez 2003).[1] CEO compensations contributed

[1] The study of Piketty and Saez (2003) looks at income and wage inequality and not at the distribution of wealth. Otherwise inequality should be even larger.

substantially to this development. CEO compensation peaked in 2000 with a percentage increase of 570% from 1990. In 2002 the percentage increase from 1990 declined to nonetheless 280% (see Chart 2). U.S. corporations set the highest levels of CEO compensation in the world (see Chart 1) and the gap in CEO pay has widened over the past decade mainly due to the importance of stock options in executive compensation packages. While in 1980 only 20% of the compensation of U.S. CEOs was tied to stock market performance, CEOs actually receive about 40% of their total pay from stock options (see Chart 1). Particularly for technology companies, stock options were the favorite compensation scheme. With ever rising stock prices it seemed to be a cheap way to provide incentives for executives.

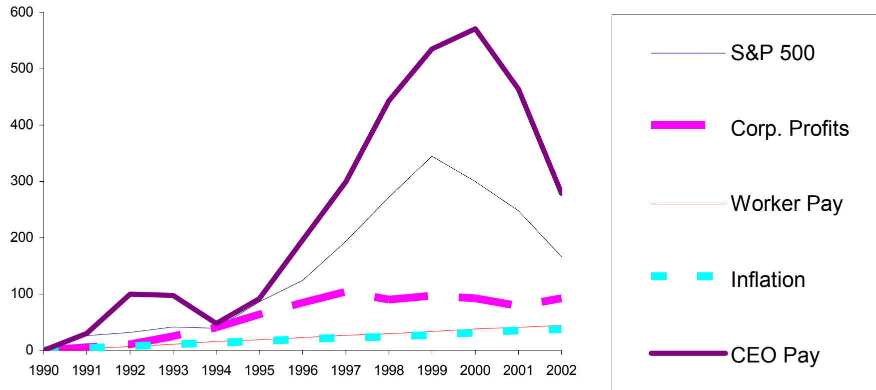
Chart 1: Remuneration of Chief Executive Officers 2001–2002, in USD



Source: Towers Perrin (2001.

While the 1980s witnessed a wave of takeover and restructuring activity, at the beginning of the 1990s a consensus view in the literature emerged that the sensitivity of pay to performance for top executives was too low (Jensen and Murphy 1990) to align the interests of managers with those of the shareholders. Hence, in the 1990s the pattern of corporate governance changed. Hostile takeovers declined substantially while executive stock options boomed. On the other hand since the 1980s there has been little progress in incorporating the poor into the banking mainstream. Surveys by the Federal Reserve Board (2003) show that in 2001 12.7% of all families had no checking account. Interestingly, among families without a checking account, 50% had held such an account in the past and 59.3% had incomes in the lowest 20 percent of the distribution.

Chart 2: Worker Pay versus CEO Pay in the U.S., 1990-2002, Percentage Change since 1990.



Source: Datastream, Business Week Executive Pay Survey, own calculations.

3.1. Monitoring Function of Capital Markets

The monitoring function of capital markets is considered as a main characteristic of financial systems in LMEs by VOC proponents (Hall and Soskice 2001, Hall and Gingerich 2002). In publicly held corporations, management (agent) is separated from fragmented owners (principal). Solutions to the collective action problems that undermine the disciplining mechanisms of shareholders aim at ensuring that the managers do not misuse resources. The main function of the corporate governance mechanisms currently in place is – according to this literature – to solve the collective action problem. According to this view the governance mechanisms serve the purpose of giving optimal incentives for executives to maximize shareholder value by constructing optimal contracts ('contracting view'). A contract is considered optimal if it minimizes agency costs, that is, the sum of contracting, monitoring and other expenditures made in achieving compliance with shareholder interest. Jensen and Meckling (1976), proponents of the agency theory of governance, describe a firm as "*a nexus of contracting relationships*". If the contracts with creditors, employees, clients, suppliers are considered as complete, then only the contracts with shareholders are open-ended. That means only shareholders have a claim on residual returns after all other contractual obligations have been met. Furthermore, if there are no agency problems, then maximization of shareholder value is decisive to economic efficiency. Under these assumptions corporate

governance rules should be designed exclusively to protect the interests of the shareholders. As contracts are generally incomplete there is apparently no guarantee that corporate governance rules designed to maximize shareholder values are efficient. In this case, other constituencies would have to be taken into consideration. However, Williamson (1985) argues that despite incomplete contracts the maximization of shareholder value is of tantamount importance because shareholders are relatively less protected than other constituencies. The assumption is that most workers can quit at reasonable costs, creditors have collateral and that only shareholders have open-ended contracts.

To mitigate the collective action problem of shareholders mainly four alternatives are discussed in the literature (Becht et al. 2002, Holmstrom and Kaplan 2003):

1) (Hostile) takeovers as a disciplining mechanism to remove inefficient managers,
2) Active monitoring by a large block holder (such as an institutional investor or a bank),
3) Election of a board of directors representing shareholder interests,
4) Executive compensation schemes to align managerial interests with shareholder interests.

Agency theory considers these approaches as substitutes. The first three alternatives lead to the question, *who monitors the monitor?* The fourth option seems to avoid this problem. Stock options shall align the interests of the chief executive officer (CEO) and shareholders directly.[2] Stock options give the CEO the right to buy stocks at a preset price at a future date. The CEO of a firm (the agent) is confronted with shareholders, creditors, suppliers and employees (multiple principals). The principals are parties with whom the CEO engages in business on behalf of the corporation. Most agency theories legitimizing stock options assume that the determinants of stock prices cannot be manipulated (Core et al. 2003). However, the recent corporate scandals have shown that stock options gave rise to a number of misleading incentives for management. Hence, the compensation scheme seems to be part of the agency problem rather than a solution to it. For instance, attempts were made to gloss over profit and balance-sheet figures in the event they lagged behind investor expectations. Managers manipulated financial statements so as to drive up stock prices, invoking their options and realizing their gains. Thus, stock options provided an opportunity for

[2] The shareholders are not a homogenous group but a collective principal. Minority shareholders and block holders may not only have divergent interests but also divergent power resources.

CEOs to enrich themselves which was facilitated by dispersion of ownership giving executives significant power. Specific features of executive compensation in the U.S. were designed with managers' welfare in mind supporting the *'rent extraction view*' as an alternative to optimal contracting (Bebchuk et al. 2001). For instance, contracts with managers abstained from filtering out industry or broader market stock price effects. As a consequence even poorly performing managers can make significant profits. The rent extraction view is also supported by the fact that compensation contracts did not place any restrictions on managers ability to sell stock or hedge the stock options. As a common practice, managers usually exercise options well before expiration and hedge their exposure when disposal is not possible. Furthermore the common practice of option repricing, the lowering of the options' strike price when the stock price falls below the original exercise price, is not compatible with providing risk-averse managers with the strongest cost-effective incentives to exert effort and maximize shareholder value. On the contrary, the possibility that the exercise price will be lowered if the stock price falls weakens incentives. Compensation packages often do not follow an internally consistent logic of incentives and sanctions. Large rewards are given when the stock market is booming while there is little financial penalty for failure as managers can never lose money from holding an option, i.e. their lowest payoff is zero percent. That cross-country difference in executive pay is concentrated at the top, while lower level U.S. executives do not receive excessive pay is a further indication of management power that allows rent extraction.

Incentives of stock options are embedded in a social context while trust seems to be an important element of governance mechanism: In 2000 almost 99% of stock option plans at major U.S. corporations received shareholder approval (Becht et al. 2002). Now, moral indignation about the huge compensations of top executives and the enormously increasing wage differences emerging over the last decades dominate (Krugman 2003). Even the proponents of this incentive instrument believe that "*the size of some of the option grants has been far greater than what is necessary to retain and motivate the CEOs*" (Holstrom and Kaplan 2003, p.13). However, how should one determine the adequate size?

In the stylized textbook model of corporate governance in LMEs, governance mechanisms in place are interpreted functionally, i.e. to strengthen the monitoring function of capital markets and to alleviate the collective action problem. As exemplified for the case of managerial compensation, practice in executive compensation seems to have aggravated the collective action problem instead of solving it. The recent wave of corporate failures, which are typically attributed to institutional features, such as lack of disclosure and transparency, weak legal protection of investors' rights, inverse incentives and misconduct of managers, are considered as deviations from the ideal model. An alternative

interpretation would be that those deviations are the 'steady state' simply resulting from the operation of market forces leading to misallocation of resources, increasing income and wealth inequalities and *exclusion of the poor*. When behavioral patterns produce large departures from the ideal neoclassical equilibrium the economics profession calls for an improvement in institutional arrangements to offset 'dysfunctional' behavior with the aim to finally bring financial and corporate behavior in line with predictions of the neoclassical model. The regulatory response to the recent corporate failures was set along these lines: a combination of strengthened regulation and an appeal to moral integrity should bring about a change in incentive structures of managers and financial market participants in general.

3.2 Information by Reputational Intermediaries

In theory, a governance mechanism that is of utmost importance for the functioning of financial markets is information dissemination by reputational intermediaries. Fragmented ownership generates a collective action problem: no one has an incentive to pay the transactions costs required to acquire the information necessary to monitor the managers. A free rider problem emerges that consists in this case of the fact that other investors can use the information gathered by one or a few resulting in under-supply of information. Hence, fragmented ownership creates the need for external monitors, reputational intermediaries, comprising external auditors, stock analysts, investment banks, bond rating agencies, lawyers and others. Investors base their decisions on information provided by these private agents. The recent corporate failures revealed the limited ability of reputational intermediaries to overcome the collective action problem and to provide for information efficient financial markets. In some cases it turned out that "*instead of providing information to external investors, the intermediaries colluded with managers and each other at the expense of shareholders*." (Gourevitch 2002a, p. 3). Thus it appears that governance mechanisms in place deviate from the idealized model description of the role of reputational intermediaries in information provision.

An issue that is broadly ignored by the literature describing the role of information in financial governance mechanisms in LMEs is that arm's length systems seem to require the financially literate individual who understands the broad range of financial services to make informative investment decisions. In recent years, there has been a wave of initiatives promoting the enhancement of financial literacy among the population where reputational intermediaries play

some role (OECD 2004).[3] The providers of financial literacy programs are a diverse group including NGOS, churches, commercial banks, the state, the Fed and colleges. They concentrate their educational programs on pension funds, home purchases and consumer credits. In these areas, classes and courses are offered to teach individuals the functioning of standard instruments and calculation methods to assess financial products and make reasonable decisions.

The literacy program providers advocate the advantages of a market-based financial system. However, in their educational efforts they do not rely upon market mechanisms but instead rely on the reputation of NGOs. The Edelman survey of trust (2003) has shown that nowadays NGOs are the most trusted institutions. Thus, many banks work with non-profit and community organizations to convey their message of financial literacy to the poor. From a business point of view the poor are an underutilized niche for financial institutions. By participating in educational programs financial institutions have a better chance to reach these households. Thus financial institutions operate in partnerships with NGOs. Information to the poor (the principal) is given by the financial institution (the agent). There are only few expert outsiders monitoring the performance of the agent.

Is the reason for the abstinence of the poor from mainstream banking a lack of information? The Survey of Consumer Finances 2001 asked all families that did not have a checking account to give a reason (Federal Reserve Board 2003). The most commonly reported answer – given by 28.6% – was that the family did not write enough checks to make account ownership worthwhile. However, 22.6% answered that they did not like dealing with banks. This response showed the largest increase since 1992 (15.3%). This points towards negative experiences made by the poor with financial institutions or, for those who never had a banking relation before, to the social issue of mistrust into the banking system. Credit and other financial services can be obtained not only from the formal financial system but also through informal networks of family friends and ethnic or community organizations. Though less studied there exists a parallel system of financial services providers that primarily serve the lower income working class. This *fringe banking* sector – as it is called by consumer advocates – is a network of check cashing centers and payday lenders. Besides the fact that

[3] "A financially literate individual understands his or her relationship to money (e.g. the need for financial security, tolerance for risk) and can read about, discuss and communicate regarding personal financial issues. She possesses knowledge of banking and credit, practices money management, understands the need for protection against unforeseen emergencies, plans for major life events and saves and invests for the future." (Vitt et al. 2000, p. 29).

fringe banks are banned in 19 states because of their potential for abuse their importance is even increasing. The number of unregulated unlicensed financial service providers is growing in the U.S. but the increase is exponential in low and moderate income and minority communities (Carr and Schuetz 2001).

A number of developments prompt concern amongst supervisory agencies and policymakers: First, the rise in consumer debt levels, the continuing decline in – already low – personal saving rates and the increase in non-business bankruptcies serve as an indication that the financial behavior of people is not sound. The younger population's access to credit has grown considerably, but younger people also have difficulties in managing their debt. Second, the larger market for financial services and increased competition between suppliers has gone hand in hand with instances of massive fraud. The result has been a lack of trust in the financial services industries (Edelman survey of trust 2003). Fed Vice-Chairman Roger W. Ferguson (2002) is quite frank about this dilemma: "*education will not be successful in an environment in which credibility and trust are lacking*".

4. Paradoxes of the U.S Financial System

Thus, financial governance for the CEOs and the poor is exercised through incentives and information. Does that mean anything more than that for different problems different governance mechanisms do exist? Rajan and Zingales (2003) claim that financial governance is "*not a cultural issue, it is an issue of incentives*". However, a number of researchers refer to culture and governance (Demirguc-Kunt and Levine 1999). In particular the World Bank has in recent years taken considerable interest in the question of how cultural factors influence the process of development. A few years ago it started a governance project finding empirical evidence of significant effects of public governance on economic development (Kaufmann 2002).[4] Based on data provided by a broad range of stakeholders around the world they constructed cross-country indicators of measuring dimensions of the quality of governance: Voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. Each of these six governance indicators combines a large

[4] What is not clear, however, is what the governance variables indeed measure conceptually as the indicators are based on perceptions and concentrate mainly on the perspectives of elites. As the surveys are about perceptions we may consider them as values themselves.

number of underlying measures of perceptions of governance. The variables have been found to be good predictors of economic growth.

Cultural links call for adequate attention being paid to contingency and particularity. Max Weber who underlined the crucial role of Protestant ethics in the development of a capitalist economy knew that the same values can have different pay-offs in different environments and different times: Some values can be very successful in a particular stage of development but less so in other historical experiences. We ask whether some values may be relevant for the rich, others for the poor. To speak of human activity means to talk of ethics. Ethics comes from the Greek word '*ethos'*, which can be translated as habit. Albert Hirschman (1996) argued that an argument in favor of capitalism was based on the belief that "*it would activate some benign human proclivities at the expense of some malignant ones*". In general, market economies cannot exist without being based on social values.[5]

Ethics is frequently used within a narrow definition. In this case, the term signifies unselfish, altruistic behavior and opposes the alleged selfishness of the *homo oeconomicus.* Theoretically maximizing behavior reflects an ethos of selfishness. In 1970 Friedman opinioned in an essay on social responsibility that the "*One and only one social responsibility of business* (is) *to increase profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."* According to Friedman's argument, the social responsibility of companies lies only in achieving maximum profit within the rules of the game and, particularly, in the context of laws. But he does not discuss the reasons why this should be the case. If we assume that laws are only rules backed by threats and that it is solely legislators' task to stipulate appropriate penal provisions for unlawful action, then the law would not have any ethical force. In this case tax evasion or the deliberate falsifying of balance sheets would be morally permissible.[6] In practice there is a search for a balance between respect of social values and the pursuit of self interest. Ethical rules are not fixed once and for all but are bound to historical circumstances. Social ideas both of justice and public welfare are subject to change. The call of policymakers to change the institutional framework, to

[5] This was pointed out already by Adam Smith in his *Theory of Moral Sentiments* (Smith 2002). Markets require, at the very least, trust and responsible action and they are formed on the basis of values.

[6] Whoever argues that the observance of the law is in the self-interest of corporate management, would also need to prove that a breach of the law cannot serve corporate interests. In corporate reality, however, it is easy to find examples of illegal behavior that pays. In a case where the risk of prosecution is low or where sanctions are minimal, illegal activity can be in line with business logic.

introduce codes of conduct, transparency provisions and ethical compliance programs, is an important consequence of the latest developments of financial markets. But to what extent are normative ethical considerations relevant?

On March 7, 2002, U.S. President Bush called for a renewed ethic of corporate responsibility: "*America is ushering in a responsibility era; a culture regaining a sense of personal responsibility, where each of us understands we are responsible for the decisions we make in life. And this new culture must include a renewed sense of corporate responsibility. If you lead a corporation, you have a responsibility to serve your shareholders, to be honest with your employees. You have a responsibility to obey the law and to tell the truth*" (Bush 2002, p.5).

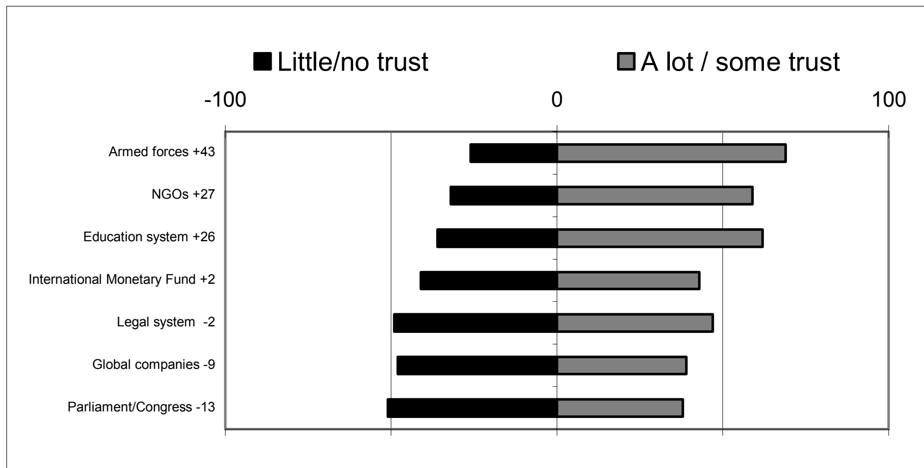
The *greed of managers* has recently become a favorite topic of financial media articles. However, greed can be justified in economically functional terms. This is because, unlike the envy of the *man in the street*, it should indeed foster public welfare in conformity with neoclassical economic models. However, the selfish homo oeconomicus in the financial sphere shall at the same time be a public welfare-oriented homo civicus. Thus, moral suasion is applied against supposedly *greedy CEOs* (World Economic Forum 2002, Greenspan 2002). A success of this governance mechanism would require that CEOs – as they are monitored within short time periods – have to act, in some cases, against their rent maximization interests on the basis of ethical values. And indeed there are a few examples when CEOs declined to accept their bonus at times when layoff announcements were made (Klinger and Hartman 2002). However, what is more important than this vote for signalling integrity is that the incentive concept of financial governance itself is a concealed value judgement. Financial capital shall educate CEOs to be responsible to their shareholders and education takes the form of disciplining or as Holmstrom and Kaplan state "*the capital markets disciplined managers who had ignored shareholders for the benefits of themselves and other stakeholders*" (Holmstrom and Kaplan 2003, p, 7), In this understanding the capital market becomes a moral entity and the people an object of the ethical norm.

According to the fifth annual global CEO survey conducted in conjunction with the World Economic Forum, asking 1161 CEOs from 33 countries, 68% agree that corporate social responsibility is vital to profitability. When asked which stakeholder groups create the greatest incentives for their corporate activities, the CEOs strongly emphasized three key actors: employees and government bodies followed by customers. The investors rank even behind the board of directors. Furthermore, the survey results indicate that ethics becomes a strategic issue of relevance to CEOs and does not only mean philanthropy.

The chairman of the Fed, Alan Greenspan, realizes the limits of incentives and regulatory rules and stresses the importance of values "*Rules cannot substitute for character. In virtually all transactions we rely on the word of those*

with whom we do business" (Alan Greenspan 2002, p.6).[7] We may assume that ethical values in financial governance gain importance in situations of a need for trust. The *Voice of the People survey* of Gallup 2002 studies the level of trust across 47 countries for 17 different institutions that "*operate in the best interest of society*" (see Chart 3).[8] The findings reveal a global public opinions climate that is very critical of democratic institutions and companies.

Chart 3: Trust in Institutions to Operate in Society´s Best Interest



Source: Gallup (2002).

Financial literacy programs are non-market instruments to confront a market failure. But theoretically, the market failures could be addressed by two other alternatives: First, a market-oriented governance mechanism would have to rely on incentives for financial institutions to build up reputation vis à vis the poor. The second alternative to the promotion of financial literacy would be to

[7] However, this is quite close to what Groucho Marx once said: "*There is one way to find out if a man is honest –ask him. If he says yes, he is a crook"*.

[8] It included face-to-face or telephone interviews with 36,000 citizens across 47 countries on six continents. Results are statistically representative of the views of 1.4 billion citizens. The principal democratic institution (i.e. parliament, congress etc.) in each country is the least trusted of the 17 institutions tested followed by companies. Two-thirds of those surveyed worldwide disagree that their country is "*governed by the will of the people*".

mandate low cost access to banking. These two alternatives are however not considered: the financial literacy programs aim at improving the financial knowledge of individuals to change financial behavior. Conceptually it remains unclear who shall be protected, the poor from fraud of financial institutions or the banks from failure of the poor? From the official discourse of financial literacy efforts one has to conclude both. "*An educated investor is the first defense against fraud*" (Pitt 2002; 3).[9] Financial education can be either understood as a component of consumer protection or as a substitute for stronger consumer regulatory protections.

An indication that it shall substitute regulation is its ideological embeddedness. As Treasury Secretary Paul H. O`Neill argued in his testimony before the Senate Committee on Banking, Housing and Urban Affairs, February 2002: *"Financial education can be compared to a road map to the American dream. I believe that we need to teach all Americans the necessary skills to read that map, so that they can reach the dream".* The U.S. Treasury is quite explicit on the ideological aim of financial literacy programs; it "*permits people to believe that their ambitions do not have to be limited*" (White Paper 2002, p.16).

How effective are the financial literacy efforts for the poor? Recent surveys show that high school seniors in the U.S.A in 2002 know even less about credit cards, retirement funds, insurance and other personal finance basics than they did five years ago. Despite of all the educational efforts the knowledge of high school children has declined (Jump Start 2002).[10] At a hearing of the U.S. Senate Committee on Banking, Housing and Urban Affairs, on the "*The State of Financial Literacy and Education in America*" Denise Voigt Crawford, Securities Commissioner, had to admit: "*On average, the general public is financially illiterate. Despite numerous, well-intentioned efforts over the last few years to increase investor knowledge, recent surveys on financial literacy are finding nearly the same dismal results that were found in surveys five or more years earlier*". There is evidence that part of the problem lies in the fact that consumers seem not to act on the information provided to them in the expected manner (Jump Start 2002). Many times they do not make use of the information provided or they do not understand it.

Empirical studies to measure the efficacy of financial education come up

[9] The U.S. securities and exchange commission (SEC) has created a fake scam site, www.mcwhortle.com illustrating what their main messages for investors are: "*if it sounds too good to be true, it is;… if it is that good it will wait;… beauty isn't everything."* The main idea of these jokes is: *do not trust.*

[10] The Jump Start survey consisted of a written 45 minute examination administered to 4,024 12th graders in 183 schools across the U.S. (Jump Start 2002).

with ambiguous results. A study by Freddie Mac, one of the largest purchasers of home mortgages in the U.S.A, found that homebuyers who obtained homeownership education have reduced rates of loan delinquency. A study by the National Endowment for Financial Education showed that nearly half of the high school students that participated in financial-planning programs saved more as a result of the program. And another Freddie Mac study shows that learning the general principles of sound financial behavior is more important than detailed information on financial transactions. However, the most important source about personal finances is personal experience (Braunstein and Welch 2002).

Fed Vice-Chairman Roger W. Ferguson (2002) points to the regular tendency for myopic financial behavior even among the most sophisticated individuals. In a study of defined contribution plans by James Choi one-third of self-reported under-savers said they intended to increase their saving rate in the next few months but almost none made a change in their 401(k) saving rate (Ferguson 2002). Ferguson concludes that neoclassical economics with its strong assumptions on rational behavior is of limited explanatory value for real behavior. Most studies on the effects of financial literacy programs show that households do not act as required by orthodox economists` models. Even in the presence of reliable information a self-destructive behavior can be observed. Self-destructive aspects of consumer behavior in finance matters are not cured by information. Mulainathan and Thaler (2000) suggest for instance that the lack of self-discipline of financial consumers necessitates strategies that force savings (automatic enrolment in 401(k) investment plans).

If financial literacy programs do work poorly in improving the capacity for information absorption and rational calculation, what is their usefulness? Individuals *empowered* by financial education can be expected to be more confident in their own ability to engage in financial transactions. The primary purpose of financial literacy programs is to discipline the uninformed poor how to behave in a way that makes public regulation obsolete and enables the solution of problems by market forces. Get everyone to calculate like a rational private investor and the demands for an activist state will diminish. People shall not feel in need of state protection but see themselves as rational, self-reliant individuals taking their fate in their own hands and contributing to their own wealth and well-being by engaging in financial transactions.

But the management of risk has two dimensions: integrity and expertise. While the latter can be dealt with by financial literacy programs for the poor the former remains an open issue. The market is also not protecting rich investors from being defrauded but at least there are regulations in place. The poor are offered financial services that are not covered by consumer protection laws and regulations. And lacking integrity of the so-called agent has more severe consequences for the poor. Poor investors who lost their retirement accounts

following the advice of analysts have presumably no second chance. Monitoring is costly for any principal but for the poor even more so, as they largely remain without support of reputational intermediaries. Shareholders have, in comparison to the poor, relatively low monitoring costs.

5. Acceptance of Inequality: the Common Denominator of Financial System Paradoxes

"*Our society, I believe, accepts and approves a large measure of inequality . Americans commonly perceive differences of wealth and income as earned and regard the differential earnings of effort, skill foresight and enterprise as deserved*." (James Tobin 1970).

The financial governance mechanisms in place are largely viewed as a set of coherent, though sometimes economically inefficient, instruments to solve for the principal-agent problem. In market-based systems financial markets and intermediaries channel society's savings directly to investment projects that have to be monitored by capital owners. In literature on corporate control the structuring of managerial compensation such as stock options and information provision by reputational intermediaries have become important elements of financial governance in exercising corporate control by shareholders. However, investigating the position of the highest versus the lowest income classes vis à vis the financial system reveals that a set of different, incoherent instruments of financial governance are in place.

Table 3: Financial Governance Paradoxes

	Rich (CEO)	**Poor (unbanked)**
Principal	Shareholders	Low income private households
Agent	CEO	Financial institutions
Agency problem	Rent seeking	Unclear principal-agent roles
Solutions to the agency problem:		
Monitoring	Reputational intermediaries (auditors, rating agencies, research analysts)	*Educated principal*
Representation	Lobbies	Advocates for the poor: churches, NGOS, Fed, banks
Representation problem	Powerful insider	Powerless outsiders
Ethical discourse	*Social responsibility*	Individual responsibility
Problematic habits	Greed	Abstinence, ignorance
Official policy tradeoffs	Corporate responsibility versus shareholder value	Informed investor versus fraud avoidance

First, both governance mechanisms, the ones for the rich and the ones for the poor, do not work in the way asserted by their proponents. Neither do stock options ensure an increase in the performance of firms nor do financial literacy

programs show up to now changing behavior, sometimes they do not even increase knowledge. *Second*, to solve for the agency problem the rich and the poor are incited to play according to quite different sets of rules. Thus, the incentives in place for the CEOs differ from the financial governance mechanisms for the poor. *Third*, and most importantly, the different forms of financial governance for the rich and the poor do not only point towards principal-agent problems to be solved, but also towards a representation problem (see Table 3). The lobbying activities of financial institutions and shareholder activism allow an extended utilization of the financial system. The financial sector has a high interest representation. The interests of the poor are to a great deal not organized and thus excluded from the political decision making process. Many of the latter do not use the traditional banking system and remain clients of expensive fringe banking without consumer regulation and protection. And financial literacy efforts take wealth inequality as a brute fact of U.S. capitalism.[11]

To solve for the representation problem requires either inclusion mechanisms for the excluded or a hegemonic ideology legitimizing exclusion. A hegemonic discourse is the narrative of the unavoidable necessity of individual responsibility to achieve overall welfare enhancing market efficient outcomes. *Rewards for the rich and rhetoric for the poor* are embedded in the framework of the neoliberal hegemonic discourse that legitimizes persisting and growing inequality.[12] Without ideology, financial governance paradoxes would form an enigma of disconnected facts.[13]

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[11] Furthermore, financial literacy is not for the extreme poor who do not have internet access, who do not own television and who do not attend events of neighborhood communities.

[12] The acceptance of inequality is well documented by the General Social Survey (GSS) conducted since 1972. The American publics' notion of justice depends more on opportunity than on achievement. In the GSS 1993 over 86% rather favoured "*promoting equal opportunity*" over "*promoting equal outcomes*". The GSS 1996 indicates that fewer than one-third of the respondents agreed with the statement, "*It is the responsibility of the government to reduce the differences in income between people with high incomes and those with low incomes*" (see National Opinion Research Centre, "Codebook Variable: EQINCOME". http://www.icpsr.umich.edu/GSS/rndl1998/merged/cdbk/eqincome.htm.

[13] By simple illustrations the poor get an idea of their likely wealth growth. Over a 10-year period saving USD 3,000 in a shoebox would be worth when adjusted for inflation only USD 2,223. The same sum invested in a 10-year Treasury note would have grown to more than USD 5,000 by 1999. Investment in an SP index fund would have yielded USD 9,180 over that period. And the illustrative point of this simplifying table: if families had

Thus, finally we have to ask about the beliefs that shape financial governance mechanisms. U.S. citizens do not care much about inequality in comparison to Europe. Alesina et al. (2001) report, using data from the World Values Survey, that "*71% of Americans, but only 40% of Europeans believe that the poor have a chance to escape from poverty*". While in Europe the poor are generally considered to be unfortunate but not personally responsible, the majority of the Americans believe that the poor can work their way out of poverty. When people are poor U.S. citizens do not consider this as bad luck but rather assume the poor are responsible for their poverty. According to Alesina et al. (2001) U.S. citizens redistribute less than Europeans for three reasons: first, because the majority believes that redistribution favors racial minorities; second since U.S. citizens believe that they live in an open and fair society, and that if somebody is poor it is his or her own fault, and, finally, because the political system is geared toward preventing redistribution. The political system is likely to be endogenous to these basic beliefs. Instead of providing financial governance mechanisms that allow redistribution to ethnic minorities, the majority of the unbanked, – e.g. by providing low cost banking –, the poor are disciplined by financial education.

Conclusions

Economists engage in debates whether a transformation of financial systems towards a U.S. style model will take place. However, sweeping statements about the desirability of a specific financial system without a contextual analysis are misleading. The U.S financial governance mechanisms do, as exemplified for the case of managerial compensation and the role of information acquisition, not appear to be too similar to economists ideas about optimal contracts and incentives. We argue that the VOC literature in relying on a principal-agent description of financial and corporate governance has missed important incoherencies. Extending the analytical framework on values allows to shift the perspective to real world phenomena and to question overly abstract models.

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a prophetic inside and invested their savings in Microsoft stocks their wealth would have grown to USD 211,360.

Table: Example: Nominal Value of Saving, USD 3,000

year	shoebox	Treasury note	SP 500 Index Fund	Microsoft Stock
1989	3,000	3,000	3,000	3,000
1999	3,000	5,072	9,180	211,360

Source: Carr and Schuetz 2001, p.11.

We have shown that financial governance works in an incoherent and paradoxical way. We analyzed the ambiguities of governance mechanisms for CEOs and the poor. While, according to the principal-agent view of financial governance, the links to the financial system for the rich and the poor should probably differ only according to their different resources as being wealthy broadens the choices one can make, we show that governance mechanisms differ fundamentally for the lower and higher income classes, both in terms of financial incentives and value construction. The financial behavior of the poor oscillates between ignorance and abstinence. The governance mechanisms for the poor are conceptually coherent as they combine financial education to learn to maximize revenues with a discourse of egoistic values. However, this pattern does not correspond with the policy suggestions from the principal-agent theory because the suggested solution that the agent (financial institution) should educate the principal (poor) would not even theoretically solve an agency problem. The financial behavior of CEOs oscillates between the poles of shareholder maximization and rent seeking. As the rich are incited to maximize individual revenues, moral suasion is exercised in parallel against exercising such behavior. The discourse of corporate responsibility shows the incoherencies of governance mechanisms for CEOs.

Paradoxical phenomena in the U.S. financial system reach from efficiency increasing incentives that at the same time induce misguiding behavior, from ethical norms that degenerate to legitimizing facades, from individual autonomy increasing efforts that lead to growing dependence on integrity. These paradoxes have preserved the stability of the U.S. variant of capitalism.

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