Two moral deficits of modern finance abstract

In this paper we examine some of the distributive implications of financial markets. Financial markets are the key institution for allocating capital in society, and whether they can do this efficiently is of the utmost importance. Importantly, financial markets determine both the level of investment that occurs in an economy, and which particular projects savings are allocated to. Some economies—most notably the UK—have seen chronic under-investment for decades, while other economies—most notably China—have seen over-investment in the same period. Sometimes, financial markets systematically allocate capital to non-productive or speculative assets. Bitcoin is the best contemporary example: at the time of writing over a trillion dollars of society's wealth is tied up in this speculative object that does not contribute to economic productivity. At the same time, society has failed to allocate enough capital to socially important goals, like advancing the green transition.

That is the macro-perspective on capital allocation; next we examine the micro-perspective on asset allocation. Investing is the art of balancing risk and reward. Modern portfolio theory, the canonical theoretical approach in contemporary finance, conceives of risk as price volatility of assets, and further breaks this risk down into idiosyncratic and systemic risk. The prudent investor diversifies to eliminate her idiosyncratic risks, ultimately owning an index fund that allocates capital just as the market does because, according to the efficient market hypothesis, the market's allocation of capital is optimal. The index fund revolution, we argue, has lead to a systemic overpricing of assets because diversified investors are willing to pay more for assets than are non-diversified investors, and because widespread common ownership of different corporations eliminates incentives for firms to compete with one another, increasing profits.

Now we can turn to the normative, distributive implications of capital allocation through financial markets. Systemic overpricing of assets benefits those who own assets already. In our society, older people own most of the assets. Asset owners can borrow against assets or sell them to fund consumption when asset prices are high. High asset prices not only benefit older people, but they harm younger people, because high asset prices today imply low expected returns for the future. Hence, asset prices are a key indicator of intergenerational inequality, and an important locus of distributive conflicts between the old and the young. In the United States, at least, asset prices are a more important locus of intergenerational distributive justice than government pension schemes.

Second, we develop a luck egalitarian critique of the manner in which the financial markets distribute valuable resources. Peoples' ability to bear risk—and accordingly how much they can benefit from participating in financial markets—is usually not something that is under their control. It is determined by their age, their life situation and their attitudes to risk. Importantly, one's ability to bear risk is proportional to the assets one has: poorer individuals cannot afford to bear risk and have larger liquidity requirements. It is important to remember that just over half of American adults participate in the stock market in the first place, so the wealth that it creates is not widely shared, particularly among individuals who do not participate in the stok market for reasons that are largely outside their control.