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Financialization of Non-Financial Corporations in the US: Implications on the Labor Market

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Abstract: By entering into new relations, financial services ceased to be a domain of the banking system and has proliferated to the activities of non-financial corporations. The increasing investment in financial assets impacts job creation, production activities, innovation and the competitiveness of U.S. corporations. A rising share of internal funds paid to financial markets in the name of increasing shareholder value is at the expense of declining real wages. The management goal of meeting the expectation of financial markets reinforces short-termism in decision-making and results in the slowdown of real capital accumulation.

The financial sector is at the center of the debate on the current economic crisis. I will leave the complexities of how financial institutions contributed to this situation for other researchers, as well as why, in the middle of the crisis in 2010, hedge fund managers reported the highest earnings in history and bank managers received generous bonuses. I also will not address the ability of the financial sector to take advantage of its political power and demand public bailouts. Rather, I direct your attention to finance as an immanent characteristic of the existing economic system. The financial sector has been an important part of economics since its origin, but only recently has it transcended all relations, including personal, leading to a change in economic and social production.[1] Financial services ceased to be a domain of the bank system but became an intrinsic feature of new financial corporations, funds, households and nonfinancial corporations. The purpose of this article is to shed light on the penetration of finance into the activities of nonfinancial corporations, so I will focus on the relations of finance with productive activities.

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1 Fine, B. (2007) 'Financialization, Poverty and Marxist Political Economy', Poverty and Capital Conference, 2-4 July 2007, University of Manchester

Financialization and its Effects

Financialization is understood as a rise in investment in financial assets along with a decline in accumulation of physical assets, which has been a feature of recent decades. This shift toward domination of financial investment over real investment cannot be separated from its connection to other processes of past decades, which contributed to the current situation. Market deregulation was complemented by the deregulation of the banking sector in the early 1980s[2], along with privatization and increased commercialization. Market logic and reliance on the private sector have gone beyond the sphere of economics and subordinated social policies, such as education, housing and health sectors. Financial assets not only expanded in volume but more importantly proliferated into new spheres in which they were previously absent.[3]

For mainstream economic theory, easy access to finance equates with the expansion of productive activities of firms. However, problems arise when financial investments bring higher profits than real investments.[4] Additionally, decision making in light of such profitability is facilitated by a new shift in corporate governance. In the 1970s, a principle of shareholder value transformed the way companies derive their profits, accumulate assets and perceive their own roles. Increased capital mobility changed the perception of firms, which came be regarded as "bundles of assets to be traded," capturing the value as opposed to creating it.[5]

The transformation of corporate governance has been addressed using different terms. Crotty coined terms of "patient and impatient financial markets" to stress that the previous era emphasizing long-term growth and personal relations between investors has been replaced by a new era (the era of financialization) of short-term goals and changing managerial incentives.[6] The system of remuneration, awarding managers who create the greatest value for investors, has simply reflected market logic. The emphasis on efficiency, which is defined strictly in monetary terms, is at the center of the performance

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2 Deregulation included reduction in reserve requirements, the formalization and tightening of capital requirements, the deregulation of deposit accounts and the liberalization of the rules and policies regarding geographical diversification, see Lazonick and O'Sullivan (2000) 'Maximizing shareholder value: a new ideology for corporate governance', *Economy and Society* 29 (1), pp. 13-35

3 Fine, B. (2010) 'Locating Financialization', *Historical Materialism* 18, pp. 97-116

4 See Tobin 1965 for an early analysis of the phenomenon, also Tobin 1997

5 Fine (2007) quoting Froud and Williams (2007)

6 Crotty in Orghazi, O. (2007) 'Financialization and Capital Accumulation in the Non-Financial Corporate Sector: A Theoretical and Empirical Investigation of the U.S. Economy: 1973-2003', Working Paper No. 149, Political Economy Research Institute

of companies.[7] Such understanding of efficiency is dangerous, as it favors finance (capital) over labor and productivity of labor (as opposed to productivity of property). In the name of creating shareholder value, companies are being restructured in order to meet the expectations of financial markets. Management is responsible for increasing the value of the corporation in the form of profits for shareholders. Just to be clear: It is not this race for profit that has changed but the nature of the race, as cleverly pointed out by Stockhammer:

"Of course, companies have always sought to maximize profit. What is new is the drive for profit through the elimination of productive capacity and employment. ...Financial markets today directly reward companies for reducing payroll through closures, restructuring and outsourcing. This reflects the way in which financialization has driven the management of nonfinancial companies to 'act more like financial market players'". [8]

Crotty reinforces short-termism, resulting in the slowdown of real capital accumulation in the U.S. compared with earlier periods.[9] As a result, in the U.S. (and other countries of OECD, such as France and the UK), we observe finance gaining a dominant position over industry. A rising number of nonfinancial corporations derive their profits not from production but from operations in financial markets.[10]

While in the 1950s households owned 90 percent of corporate stocks, it is now institutional investors who control the U.S. market.[11] The roles of managers is conflicting, creating multiple levels of decision makers as well as rentiers, whose income is derived partially from the performance of the firm and its stock market valuation in the form of stock options. Their interests and performance depend on the institutional settings of the economy and the firm in particular, underlying their political role.[12] Competition in the market forces

7 Fine, B. (2007) 'Financialization, Poverty and Marxist Political Economy', Poverty and Capital Conference, 2-4 July 2007, University of Manchester

8 Stockhammer quoted in Rossman, P. and Greenfield, G. (2006) 'Financialization: New Routes to Profit, New Challenges for Trade Unions', Labour Education, Quarterly Review of the ILO Bureau for Workers' Activities, no. 142

9 Crotty 2005 in Orghazi 2007

10 Fine, B. (2009) 'Neo-Liberalism in Retrospect? – It's Financialisation, Stupid', Conference on Developmental Politics in the Neo-Liberal Era and Beyond, 22-24 October 2009, Center for Social Sciences, Seoul National University

11 Institutional investors also tend to hold stock for shorter periods, one year on average. In 2000 households held only 42 percent of public shares. See Crotty, J. (2003) 'The Neolibral Paradox: The Impact of destructive Product Market Competition and Impatient Finance on Nonfinancial Corporations in the Neoliberal Era', Research Brief 2003-2005, Political Economy Research Institute, University of Massachusetts Amherst

12 Stockhammer, E. (2004) 'Financialization and the slowdown of accumulation', *Cambridge Journal of Economics* 28 (5), p. 723

management to seek short-term gains. In order to maintain the high value of stock options on the financial market, firms opt into buybacks. From 2001 to 2010, the companies in the S&P 500 Index spent about $3 trillion on stock buybacks.[13] The issue is that many nonfinancial corporations now spend more on stock buybacks than on investment either in production activities or innovation.

Labor as a Form of Capital

In addition to managers and investors, prioritizing shareholder value has consequences for the workforce as well. The need for flexibility in investment, a shift of the competition from a product-driven market to a financial one, requires flexibility in employment relations. The neoliberal policies of the 70s and 80s brought labor instability, worsening working conditions and pay schemes benefiting employers. Some authors stress that the increased role of finance in employment relations, such as pension schemes, are a form of modern exploitation; however, due to the complexity of the issue, I would like to avoid such claims. I will, however, argue that labor has been reconstituted as a form of capital, requiring the same fluidity and mobility as its financial counterpart. The high investment, productivity, employment and wage nexus of the post-war period has been replaced by low investment (in production), low productivity (despite high "efficiency"), low wages and casual employment.[14] The ceaseless pursuit of the optimal combination of skills and cost[15] from the side of firms has resulted in insecurity, fragmentation and polarization of the workforce. Income for the bottom 20 percent of the U.S. households rose only by 6 percent between 1979 and 2005.[16] Despite the stagnant wages, consumption in the U.S. rose thanks to the expansion of financial services, which "financially empowered" the households. Nevertheless, this empowerment goes hand in hand with the necessity of households to "learn how to manage the risk." Even the IMF confirms the new role of households, which has become "a shock absorber of last resort."[17]

Increasing debt in households has been a result of the retreat of the state from public sectors. Household income needs to account for education, health, pensions and other provisions, which used to be the domain of the

13 Lazonick, W. (2012) 'Financialization of the U.S. Corporations: What has been lost and how it can be regained', The Academic-Industry Research Network

14 Fine, B. (2007) 'Financialization, Poverty and Marxist Political Economy', Poverty and Capital Conference, 2-4 July 2007, University of Manchester

15 Thompson, P. (2013) 'Financialization and the workplace: extending and applying the disconnected capitalism thesis', *Work, Employment& Society* 27 (3), pp. 472-488

16 Zalewski, D. and Whalen, C. (2010) 'Financialization and Income Inequality: A Post Keynesian Institutionalist Analysis', *Journal of Economic Issues* 44 (3), pp. 757-777

17 IMF (2005) Global Financial Stability Report: Market Developments and Issues, IMF's Financial Stability Report 2005, September 2005

state. Rising unemployment, which at its 2010 peak reached 10 percent,[18] is accompanied by increased inequality due to income distribution skewed in favor of the top 20 percent of the population. From 1979 to 2007, their after-tax income rose by 65 percent, while that of the bottom quintile rose by 18.3 percent. The after-tax income of the top percentile increased by 277.5 percent in the same period. [19] Moreover, as capital gains represent a large proportion of the income of top 10 percent of the population, stock fluctuations make their income extremely volatile, as shown in Figure 1. As discussed earlier, Lazonick sees rationalization, marketization and globalization encouraged by

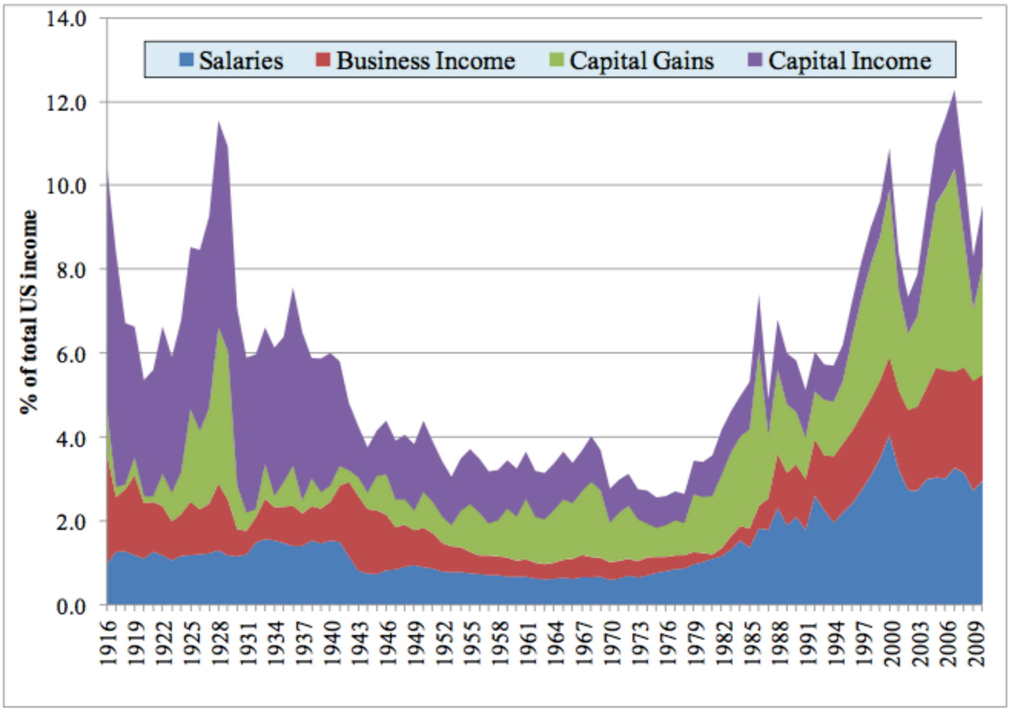

Figure 1 Composition of income of the top 0.1 percent of the U.S. population (1916-2010)

market reforms as the main reasons for the structural character of the current unemployment rate.[20] Employment strategies adopted by U.S. corporations are

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18 Freeman, R. B. (2010). It's financialization!, *International Labour Review 149*(2), 163–183.

19 Lazonick, W. (2012) p.11

20 For detailed comparative analysis of corporate governance in post-war period and neoliberal period see Lazonick old and new economy business models in Lazonick 2012

pursued purely for financial gains. Therefore, corporations do not have incentives to invest in job creation.

Stock Buybacks and Decline in Innovation

The negative relationship between financialization and real investment is not manifested in the increasing accumulation of financial assets, resulting in the elimination of productive capacity and employment. Innovations and other physical assets are not mobile enough to be part of management's reward structure and are therefore unsuitable for impatient markets. Nonfinancial corporations cut investment and innovation and channel resources to short-term capital gains instead. Figure 2 shows how payment from nonfinancial corporations to financial markets is increasing. Interestingly, studies showed that in contrast to the expectation of mainstream economic theory, gains from capital markets are not used for financing real investment. In fact, higher financial payout ratios decrease real investment, as funds are directed away from innovation, wages and production. These findings, however, do not apply to small firms, which tend to use income from financial investment to finance real investment in the future. [21]

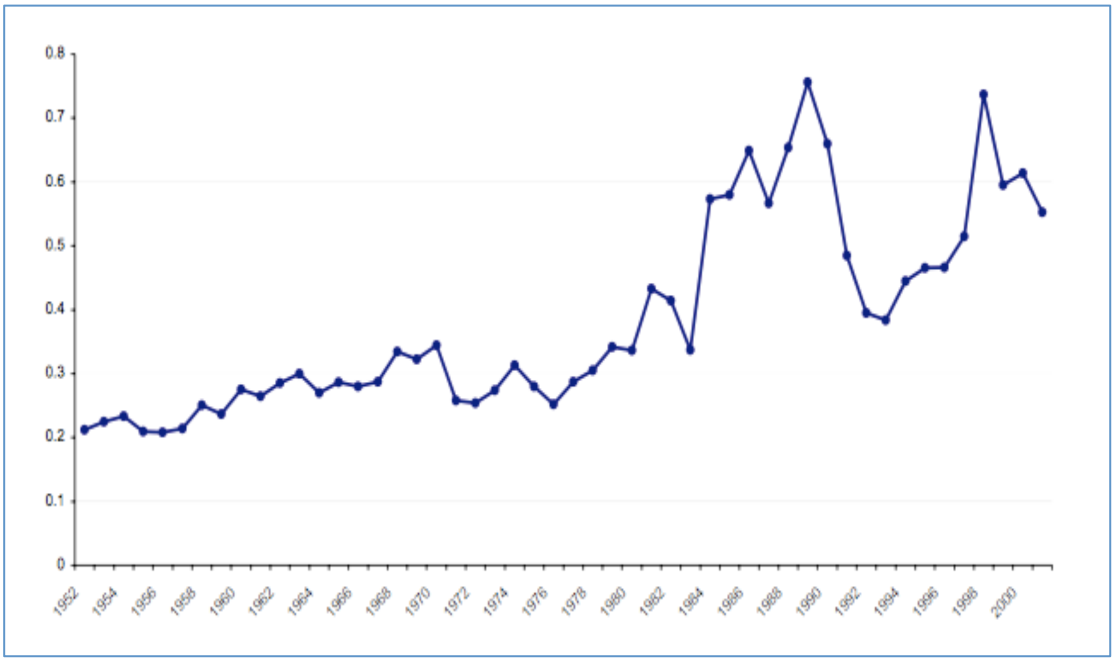

Figure 2 ***Total payment to financial markets by nonfinancial corporations as a percentage of cash flows***[22]

[21] Orghazi 2007: 27-28
[22] Crotty 2003: 6

The slowdown of innovation and subsequent decline in competitiveness of American companies has caught up with major players in the ICT and energy sectors. As noted by John Doer, partner in the venture capital firm Kleiner Perkins Caufield & Byers and co-founder of an initiative for innovation in energy sector in the U.S., "*America has simply neglected to support serious energy innovation. My partners and I found the best fuel cells, the best energy storage, and the best wind technologies were all born outside the United States.*" [23] Similar calls for increased funding in nanotechnology research came from the ICT industry. Craig Barrett, CEO of Intel (March 2005), emphasized, "*U.S. leadership in the nanoelectronics era is not guaranteed. It will take a massive, coordinated U.S. research effort involving academia, industry, and state and federal governments to ensure that America continues to be the world leader in information technology.*" Despite the awareness of the inferior situation in research, some companies continued to spend more on stock buybacks than R&D. Intel might have called for government intervention and coordinated an effort; however, that did not stop it from spending an amount equaling 94 percent of its R&D expenditure on buybacks. Table 1 summarizes expenditures on buybacks, dividend payouts and R&D of 10 corporations with the highest volume of stock repurchase. Notably, in eight cases repurchase payouts were greater than net income.[24]

RP Rank 2000-2008	Company	RP/ NI%	TD/ NI%	(TD+RP)/ NI%	R&D/ SALES %	RP/ SALES %
1	EXXON MOBIL	58	25	83	0.2	5.7
2	**MICROSOFT**	95	51	146	**15.5**	27.6
3	IBM	96	17	113	5.6	8.9
4	BANK OF AMERICA	53	58	111	0.0	7.9
5	**CISCO SYSTEMS**	138	0	138	**15.7**	23.4
6	GENERAL ELECTRIC	34	52	86	1.7	3.9
7	**PFIZER**	73	71	144	**17.7**	13.1
8	**INTEL**	90	24	114	**14.5**	16.2
9	PROCTER & GAMBLE	76	43	119	3.4	9.3
10	HEWLETT-PACKARD	129	22	152	4.4	6.2

Table 1: Payout ratios and investments in R&D between 2000-2008[25]

23 John Doer is a co-funder of American Energy Innovation Council, established in 2010 which put out a plan for "America's Energy Future. For more details see Lazonick, W. (2009) 'The New Economy Business Model and the Crisis of U.S. Capitalism', *Capitalism and Society* 4(2)

24 Ibid

25 For complete statistics of Top 50 purchaser see Lazonick 2009.

Conclusion

In conclusion, the increased involvement of nonfinancial corporations in the financial market, accompanied by a shift in investment patterns, has resulted in the crowding out of funds that can be utilized for the expansion of jobs, production activities and innovation in favor of short-term financial investments in the name of increasing shareholder value (and management remuneration). The argument that funds collected through the financial market in the short term can add to a firm's internal fund in the long run remains a wish of neoclassical theory. On the contrary, nonfinancial corporations increasingly use internal funds and loans to finance investment in capital markets, including paybacks and dividend payouts. As a result, the share of internal funds paid to financial markets has risen dramatically,[26] decreasing the amount of resources available to increase competitiveness in product markets affecting employment and real wages. As consumption can be financed through a wide range of financial instruments accessible to households, high wages à la Ford are no longer necessary. When in the 1950s General Motors offered to contribute to pension funds in exchange for slower growth of wages, few expected the pensions to be used to buy stocks and bonds. The pensions did not invest in increasing employment or the quality of working conditions. As the real economy does not grow at a rate to meet growth of debt, managers have resorted to downsizing and outsourcing. The instability of the pension funds designed by GM itself contributed to its bankruptcy.[27] GM is not the only company taking advantage of its employees' pensions. IBM workers filed a lawsuit in 2004 after changes in the pension scheme were designed to help the company stay competitive (see recent Washington Post article).

The financialization of corporations, crowding out of the state and the dominant position of finance, however, cannot be depicted separately from global financial arrangements. Even though financialization is context-specific and its impacts vary across economies, the dominance of the U.S. dollar as a reserve currency is an uncommon privilege. This position protects the U.S. dollar from devaluation, speculative attacks and outflow of funds, which would usually happen if such a severe economic downturn were to occur in other countries. In addition to the uniqueness of the U.S. dollar, the capital market liberalization advocated by the U.S. has contributed to an increased reliance on high levels of reserves as a safety net.[28] Therefore, other countries have become accomplices of the U.S. in its effort to sustain its value.

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26 Orghazi 2007

27 Hudson, M. (2010) 'From Marx to Goldman Sachs: The Fictions of Fictitious Capital, and the Financialization of Industry', *Critique: Journal of Socialist Theory* 38 (3), pp. 419-444

28 Fine, B. (2010) 'Locating Financialization', *Historical Materialism* 18, pp. 97-116

Furthermore, the state currently embraces two contradictory positions: It is making an effort to intervene in order to limit the impact of financialization while simultaneously being supportive of private capital, financial in particular. I do not only mean the recent bailouts of financial institutions, though those alone prove my point, but also the lack of structural reforms that address the above-mentioned issues. Financialization, in its connection with long-term trends of labor insecurity, deregulation, privatization and marketization, undermine the role of the state as an actor of economic restructuring.[29] The retreat of the state has put numerous spheres of social and economic life at the risk, transferring the responsibility to increasingly indebted households.

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[29] Fine, B. (2007) 'Financialization, Poverty and Marxist Political Economy', Poverty and Capital Conference, 2-4 July 2007, University of Manchester