Financialization of the US Economy

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Abstract

"Financialization" describes the increasing centrality of finance and financial considerations to the workings of the economy. This essay reviews the evidence that (i) creating shareholder value became a predominant concern for corporations since 1980, particularly in the United States, and (ii) the financial sector gained increasing prominence and power in the economy, with a number of consequences for the operations of corporations and the organization of society. Opportunities for future research are discussed including documenting the rise of securitization and its effect on the finance industry; understanding the emergence of new noncorporate forms of organization not tied to financial markets; finance and social movements; and finance and culture.

INTRODUCTION

During the past 30 years financial markets became pervasive. The number of countries with a domestic stock market doubled after 1985, and some new markets, such as those in China, grew to be worth trillions of dollars (Weber, Davis, & Lounsbury, 2009). Cross-border financial flows expanded from a trickle to a flood, as country after country reduced barriers to outside investment. Moreover, the range of things traded on financial markets spread from corporate stock and bonds to pools of home mortgages, auto loans, credit card receivables, and business loans, to exotic asset-backed securities such as Bowie Bonds and bonds backed by the insurance payoffs of the elderly and terminally ill.

In the most financially advanced economies such as the United States, financial transactions increasingly replaced the production of goods and services at the center of the economy. By the turn of the millennium, 40% of corporate profits were attributable to finance, and the richest compensation went to those running hedge funds, not those running corporations. Meanwhile, employment in manufacturing continued to decline: during the first decade of the new century, manufacturing lost one-third of its jobs, and

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during the recession that capped the decade, more people were unemployed than working in manufacturing.

The financial crisis of 2008 laid bare some of the contradictions of a financialized economy. Americans had come to treat their homes as a financial asset, and with the ready availability of refinancing, millions refinanced their homes to gain access to increased valuations, in part to make up for stagnant household incomes. When the housing bubble burst, more than one-quarter of mortgages eventually ended up "underwater" (that is, the loans were worth more than the house itself), and millions of homeowners were foreclosed. Venerable Wall Street firms, commercial banks, insurance companies, and lenders across the country went bust. But because mortgages had generally been "securitized" and sold to global investors, the damage spread widely to include banks and pensioners around the world.

In this essay we review the evidence for financialization and its impacts on the corporate economy and the broader society. Although there has been substantial research on how corporations have been affected by the shift to "shareholder capitalism," there is great unexplored territory worthy of further exploration. We suggest four broad lines of future inquiry that will enrich social scientific understanding of financialization and its effects.

FOUNDATIONAL RESEARCH

Financialization Defined

"Financialization" describes the increasing centrality of finance and financial considerations to the workings of the economy. At the firm level, signs of financialization come from the dominance of an orientation of corporations toward shareholder value. Practically speaking, this means being driven by an overriding concern with a company's share price, and with the markets that determine it. This is often contrasted with an orientation towards "stakeholders" such as employees and communities. Critics of financialization argue that "shareholder primacy" has diminished a focus on other stakeholders. At the level of the broader economy, financialization is indicated by the increasing importance of the financial sector as a source of profit and employment. For instance, it is widely reported that by 2000, 40% of the profits of US corporations came from financial activities. Finance has also become perhaps the most remunerative sector of the economy. Kaplan and Rauh (2010) report that the top five hedge fund managers in 2004 earned more than all of the CEOs in the S&P500 combined. Thus, financialization is associated with increasing inequality.

Krippner (2005, 2011) provides the authoritative account of the financialization of the American economy. Beginning in the 1970s, corporations in

the United States saw an increasing proportion of their profits coming from financial activities rather than production. "Financial activities" include income from interest payments, dividends and capital gains on investments. Manufacturing led this trend, which subsequently spread to firms in other nonfinancial sectors. Examples of this include the outsize profitability of financing units at old-line industrial firms such as Ford, GM, and GE relative to manufacturing. In many cases, industrial firms made more profits from financing the lease or purchase of their products than they did from the products themselves. Krippner also finds that an increasing proportion of profits were generated in the financial sector relative to the nonfinancial sector. The proportion of corporate profits in financial firms increased from 20% in 1980 to 30% in early 1990s. By the turn of the twenty-first century, financial industry took up 40% of entire corporate profits in US economy.

Antecedents to Financialization

There are at least four distinct views on how finance came to economic dominance within the United States and more broadly. The first attributes financialization to speculative mania. In the United States, both the stock market and the housing market saw rapid surge in prices that encouraged broad participation in these markets during the 1990s and 2000s, followed by rapid collapses. Minsky (1986) and others have argued that such bubbles are endogenous to financial markets.

The second points to factors in the corporate economy that led to the rise of shareholder capitalism, first within the United States and subsequently in other global economies. With the United States, the emergence of a corporate takeover market in the 1980s was caused by deteriorating macroeconomic conditions (inflating the value of corporate assets while depressing stock prices), changes in state policy (relaxed anti-trust restriction under the Reagan administration), and a series of financial innovations such as junk bonds. This led first to the breakup of the conglomerates into leaner and more focused firms. It also altered compensation practices to focus executive's attention on stock price, as an increasing proportion of their pay came in the form of stock options. Corporate ownership increasingly came into the hands of institutional investors driven by a financial orientation, who implicitly or explicitly encouraged corporations to spin off unprofitable divisions, lay off workers, or engage in financial engineering, all in the name of "creating shareholder value."

Third, a world-systems view, flowing out of a Marxist tradition, points to financialization as a transition point in the cycle of material expansion. This view points to the stagnationist tendencies of mature capitalism: "Advanced

industrial capitalism tends toward stagnation because the productive capacity of large, oligopolistic firms far outstrips demand for their products, especially in the absence of mechanisms to redistribute wealth to the working class (Krippner, 2011, p. 12)." In response, finance capital reasserts its power by pushing firms towards a financial orientation. According to Arrighi (2010), this transition to financialization is a more or less predictable phase among economic hegemons, as similar transitions occurred among the Genoese, the Dutch, and the British. China is the presumptive inheritor of the mantle of global hegemon.

Finally, political sociologists (most prominently Krippner) see financialization in the United States as an unintended consequence of policy shifts to avoid state crisis in the late 1960s and 1970s.

During this period, the US government increasingly faced a mismatch between the demands of diverse social groups and decreasing available revenues to meet those demands. This led to a social crisis, with increasing tension between social groups making conflicting demands; a fiscal crisis caused by the structural gap between governmental revenue and spending; and a legitimation crisis as a result of a declining confidence in government to deal with social problems. US policymakers responded to these crises by avoiding tough choices and instead delegating choice to the market mechanism, which "transformed the resource constraints of the 1970s into new era of abundant capital" (Krippner, 2011, p. 22). This master decision took the form of three specific shifts in economic policies: deregulation of US financial markets, which yielded abundant credit; increasing interest rates, which encouraged an influx of foreign capital; and changes in the overall approach to monetary policy. These policies in turn enhanced the profitability of the financial sector, which handles the flow of credit, and encouraged speculative behavior among nonfinancial firms. Notably, financialization was not an explicit aim, but an unintended consequence of upstream policy shifts.

Consequences of Financialization

The increasing centrality of finance to the American economy has re-shaped the operations of corporations, from how they are structured and connect with labor to how the proceeds from their activities are distributed. The biggest single effect of financialization has been the increased share of corporate profits going to shareholders and, to some extent, executives at the expense of labor. Dividends as a percentage of total profits in the United States doubled from 22.8% in 1946–1979 to 46.3% in 1980–2008, indicating a regime shift in how profits are allocated in favor of shareholders (Torres, International Labour Organization, & International Institute for Labour

Studies, 2009). Executive compensation is increasingly contingent on the creation of shareholder value rather than fixed. In the early 1990s, executives received 35% of their compensation via stock options, while by 2008 it had increased to 77%, making it by far the largest component of executive pay (Jarque, 2008). In contrast, labor's share of the pie, and its security, have declined. Among advanced economies, wage share for the five most financialized countries declined by 3.5% over the period of 1989–2005, while for the five least financialized countries, wage share dropped only by 2% for the same period of time (Torres *et al.*, 2009). Notably, countries with the highest union densities saw the lowest increase in financialization while countries with the lowest union densities saw the greatest increase in financialization.

The leveraged buyout (LBO) provides a microcosm of how finance shapes corporate governance. LBO is a widespread practice in corporate takeover, in which the acquisition of a firm is financed through the combination of equity and debt, and the debt is secured or repaid by the asset or future cash flow of the target company. Private equity funds typically use this practice because employing high leverage (having high debt to equity ratio) inflates the return on equity. A general tendency involved in LBOs is "quick flips", meaning private equity funds acquire the target firm and exit the firm within a year. Indeed, of all buyouts sponsored by private equity, 42% exited within the first 5 years, and the holding period of LBO is on a steep decline, from almost 80 months in late 1980s to less than 20 months in late 2000s (Strömberg, 2008). In this short period of ownership, private equity funds are incentivized to engage in corporate restructuring aimed at increasing future cash flow and divesting unprofitable asset of the target firm, in order to repay the high level of debt involved in initial buyout deal. Specifically, through renegotiating old labor contracts, private equity investors reduce staff levels and employee wage. In a study of 5000 US firms acquired in private equity transactions between 1980 and 2005, it was found that employment of acquired firms shrunk more rapidly than the firms in control group by 7% during the first 2 years after LBO (Davis, Haltiwanger, Jarmin, Lerner, & Miranda, 2011). Also, LBOs can have negative effect on other employee benefits, because buyout deals do not bind acquirers with existing agreements between firm and labor but allow them to stop contributing to the old retirement plans for employees. In addition, following LBOs by private equity firms, target firms tend to engage in more acquisitions and divestment than the firms in control group (Davis, *et al.*, 2011). The ultimate harm of LBOs is that some of the target firms in buyouts subsequently fail and go out of business, eliminating the entire employment. It is reported that 6% of all LBOs eventually fail, which is higher than

average bankruptcy rates among all publicly-traded firms in the United States (Strömberg, 2008).

At a broader level, the financialization of the corporate sector has had rippling effects on society. Job security has declined. Hacker (2006) reports that in 1982, when the unemployment rate hit almost 10%, only 12% of workers were "frequently concerned about being laid off," while the number went up to 35% in 2005, when the unemployment rate was 5%. Also, long-term unemployment (i.e., unemployment lasting more than 6 months) in 2005 was three times as high as it was in the 1960s. Pensions have become riskier, as corporations shifted from "defined benefit" pensions (where employees receive a fixed payment on retirement according to their years of service) to "defined contribution" plans (in which retirement pay depends on the performance of the market). Cobb (2012) documents that this shift was a direct result of investor influence within large corporations. Finally, corporations increasingly seek to avoid providing traditional social welfare benefits. Briscoe and Murphy (2012) finds that since the 1990s, retiree health benefits came to be seen as financial liability to investors, which made corporate employers become increasingly sophisticated in cutting medical and other retirement benefits in forms that would be invisible to their current employees.

CUTTING EDGE RESEARCH

EFFECTS OF FINANCIALIZATION ON CORPORATE STRATEGIES AND STRUCTURES

Financialization has had profound implications for how corporations are run in the United States, leading to the dominance of Wall Street over Main Street. One indication of this influence is in changing statements about corporate purpose. During the post-War era, corporate executives acknowledged obligations to a broad set of stakeholders. According to economist Carl Kaysen, "No longer the agent of proprietorship seeking to maximize return on investment, management sees itself as responsible to stockholders, employees, customers, the general public, and, perhaps most important, the firm itself as an institution." Moreover, "Its responsibilities to the general public are widespread: leadership in local charitable enterprises, concern with factory architecture and landscaping, provision of support for higher education, and even research in pure science, to name a few" (Kaysen, 1957, pp. 313–314). By the late 1990s, however, only one corporate purpose was acknowledged: the creation of shareholder value.

> "We exist to create value for our share owners on a long-term basis by building a business that enhances The Coca-Cola Company's trademarks."
>
> —*from Coca-Cola Company's 1999 mission statement*

> "Sara Lee Corporation's mission is to build leadership brands in consumer packaged goods markets around the world. Our primary purpose is to create long-term stockholder value."
>
> —*from Sara Lee Corporation's 1999 mission statement*

These statements were not pure puffery, as corporations systematically restructured themselves in an effort to appeal to Wall Street. Increased focus on shareholder value led to increases in layoff through investment in technology, and also to deunionization of labor (Fligstein & Shin, 2007). An international comparative study has also shown that in the regions where shareholder rights are stronger, hostile takeovers occurred more frequently (Schneper & Guillén, 2004). More broadly, corporate structures became increasingly industrially focused, first through de-diversification (Davis, Diekmann, & Tinsley, 1994) and subsequently through outsourcing. Executives were frank about their rationales:

> "Wall Street can wipe you out. They are the rule-setters. They do have their fads, but to a large extent there is an evolution in how they judge companies, and they have decided to give premiums to companies that harbor the most profits for the least assets."—*John Bryan, CEO, explaining Sara Lee's "deverticalization" program in 1997*
>
> "We believe the market value of The Associates is neither fully nor consistently reflected in Ford's stock price. Because the market views Ford as an automotive company, it has not fully recognized or rewarded us for our diversification in nonautomotive financial services businesses."—*Alex Trotman, CEO, announcing spinoff of financial subsidiary The Associates*

By the 2000s, many shareholder-oriented corporations had abandoned production entirely, following the model of Nike, in which production and distribution are handled by contractors.

Yet executives were hardly helpless in the face of investor pressures, and many became quite skilled in generating "Potemkin village" approaches to strategy and structure. CEOs found a way to manage the pressure through symbolic alignment with shareholder value. Westphal and Zajac (1998) found that the announced adoption of CEO incentive plans generated positive stock market returns and deterred more substantive corporate governance reform even if the change was not actually implemented. Corporate executives also rediscovered new value in old practices. For example, the financial market response to stock repurchase plans shifted from negative to positive as agency logic of corporate governance (turn to financialization) became dominant in the mid-1980s (Zajac & Westphal, 2004). Finally, executives engaged in impression management with representatives of the powerful financial sector. CEO's ingratiation towards institutional fund managers

weakened the influence of institutional ownership on corporate governance practice that may be negatively affect CEO power—such as board reform, CEO compensation, and diversification (Westphal & Bednar, 2008).

Financialization Beyond the Corporation

It is not just corporate shares and bonds that are traded on financial markets. Mortgages, business receivables, credit card debt, student loans, and even the payoffs of life insurance contracts on the elderly and terminally ill have been turned into "securities" (bonds). Thus, financialization reaches deep into the everyday lives of households. The process of turning financial assets such as loans into tradable securities is called *securitization*. The most familiar form of asset-backed security is a mortgage bond, in which hundreds or thousands of mortgages are pooled together and divided into bonds backed by the expected future payments of the mortgage buyer. Mortgage-backed securities were traditionally considered safer than individual mortgages because their cash flows were rendered more predictable via the law of large numbers.

This same basic idea can be applied to almost any regular cash flow: business loans, car loans, student loans, lawsuit payments, or insurance payoffs. Thus, banks and other businesses found that they could resell the loans they had made to access future cash flows now. Investors were happy to have new assets in which to invest, and investment banks were happy to take a fee for underwriting new securities. As the corporate sector demonstrates, responses of social actors to being publicly traded may be complex. The mortgage market showed that the dynamics behind securitization can have malign consequences on a grand scale, when speculators replaced homeowners and banks passed off weak loans as strong. Although much has been written about the financial crisis, the broader implications of securitization for society have yet to be fully explored.

KEY ISSUES FOR FUTURE RESEARCH

Most research on financialization to date has focused on documenting its occurrence and its influence on corporate structures and governance. Far less attention has gone to showing other concomitants of financialization. We here highlight four of these as domains for future research.

Securitization and the Finance Industry

One of the most profound changes made through financialization is the replacement of traditional finance with market-based finance across a wide landscape via securitization. Mortgage securitization is the best-known

form. Mortgages had traditionally been a highly local business in which a bank or thrift took in deposits in their community to make local mortgage loans. Jimmy Stewart's character explained how the traditional model of a savings and loan worked in the famous bank run scene in the movie *It's a wonderful life*.

> "No, but you … you're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house … right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them?"

A contemporary update would be very different (Davis, 2009a):

> "No, but you … you're thinking of this place all wrong. As if I held your mortgage on my balance sheet. I sold your mortgage to Countrywide 10 minutes after we closed the deal, and they sold it along with 3000 other mortgages to Merrill Lynch, which divided it into bonds that were bought by a Cayman Islands LLC, which bundled them together with other mortgage–backed bonds into a collateralized debt obligation that Citigroup sold to a Norwegian pension fund. Now what are you going to do? Stop making your payments and force those Norwegian retirees to go back to work?"

Mortgage banking went from being one of the most localized and vertically-integrated industries to one of the most global and disintegrated through the magic of securitization. We have seen some of the consequences of this new model, and countless tomes have been written on the financial crisis. The basic model of securitization—take a financial asset (such as a loan or other regular cash flow), bundle it with other financial assets, and turn it into bonds to be sold on the market—has fundamentally transformed the banking industry. In principle, almost anything on a bank's balance sheet, from credit card receivables to business loans, can be securitized, which potentially profound effects. Quinn (2008) documented the rise of the "viatical" industry, in which individuals sell the payoffs of their life insurance contracts to investors. A moment's thought reveals that this can create incredibly malign incentives: investors' returns are higher the quicker the seller dies. Television personality Larry King had sold the payoffs of his life insurance contracts to investors, but then sued to reverse the deal after giving it some thought. His lawyer stated, "The insured never knows if the guy barreling down the highway in a large truck coming in the opposite direction holds the insurance policy on his life. We don't know whether the owner is a Wall Street hedge fund or a Mafia don."

Securitization has reshaped the finance industry in ways that are only beginning to be mapped out, turning sleepy Caribbean islands into global centers of financial intrigue and undermining much of the traditional business of commercial banking. When loans are almost immediately turned into bonds, the traditional distinction between commercial banking (taking in deposits and making business loans) and investment banking (underwriting securities issuance) is ephemeral. Traditional banks are simply the brand facade for Wall Street, much as firms such as Nike are the front for goods manufactured by anonymous contractors. Securitization also links "issuers" and "investors" around the world through occult financial flows. "Through my pension plan, I may own part of my neighbor's home mortgage, auto loan, credit card debt, and be a beneficiary of his life insurance. "Social capital" had come to take on a more than metaphorical meaning" (Davis, 2009b, p. 36).

Key research questions on securitization include:

- How does the alienability of debt change incentives and economic relations? Some early evidence confirms that banks made lower-quality mortgage loans when they knew that those loans would be securitized, a problem economists refer to as *moral hazard*. Does this apply more broadly, for instance, to business loans? With what effect?
- How do people think differently when intimate things become securitized? Zelizer (1979) has explored issues such as the creation of the life insurance industry, but the prevalence of such markets has grown vast, as educational loans, insurance contracts, and credit card debt have been securitized.
- When does politics intervene in securitization? For instance, when is it disallowed to sell life insurance payoffs? (In the United States, it is illegal for veterans to re-sell their pensions, although it is nonetheless common.) What are the political limits of securitization?
- Who wields economic power in a world of securitization? If banks are no longer indispensable sources of capital, what institutions or entities (if any) have taken their place?

Finance-Resistant Forms of Organization

Recent years have seen a proliferation of new forms of organization that are not dependent on traditional market-based finance. To a large degree, the shape of formal organizations follows from the format of its financing, that is, where it gets its money and who owns the proceeds from its endeavors.

Schneiberg (2011) has extensively documented the variety of organizational forms that arose in the United States as alternatives and competitors to the

public corporation, avoiding reliance on markets for funding. Cooperatives are owned by workers, producers, or consumers rather than investors, and are still common as a way for farmers to jointly own processing equipment and distribution channels (e.g., Land o' Lakes, REI). Mutuals are owned by those who use their products, and are widespread in insurance (e.g., State Farm). Municipal companies such as water and power providers are owned by cities or other political units. In each case they provide alternatives to financially-oriented companies. Legal changes in recent years have allowed experiments in legal forms such as the benefit corporation, which in several states provides an organizational form that explicitly eschews a primary emphasis on creating shareholder value. Flexible purpose corporations and low-profit limited liability corporations (L3Cs) also provide a legal format to compete with both traditional for-profit companies and nonprofit organizations.

More recently, new forms of "crowdsourced" financing have become available. For instance, some entrepreneurs use Kickstarter as a device to raise funds for their businesses without necessarily giving up an ownership stake, and this form was legitimated by Federal legislation in 2012. New financing channels may well promote new formats of organization.

Key research questions on finance-resistant forms of organization include:

- When and where do founders avail themselves of new forms of organization? Are there particular demographic or cultural factors that encourage the new noncorporate forms?
- What cultural and institutional factors shape the format of new organizations made possible by new law and finance?
- In what industries are alternative forms more prevalent? Why?
- Do new forms of organization not dependent on financial markets yield distinctive social benefits?

Finance and Social Movements

The rise of finance and the financial crisis have been accompanied by the rise of oppositional social movements around the world, both formalized and informal. Across the globe, and beginning in the United States in September 2011, the Occupy movement created a new focus on inequality and the outsize influence of Wall Street. Rising inequality and its link to financialization became a prominent issue in public discourse in the United States for the first time in living memory. There have also been social movements within finance itself, as constituencies that regard themselves as disenfranchised within traditional corporate governance sought increased influence. Thus, institutional investors relied on the tactics of social movements to advocate for corporate reforms (Davis & Thompson, 1994).

Key research questions on finance and social movements include:

- What are the characteristic forms of opposition? How does the repertoire of contention vary among different groups in response to financialization?
- How can the power of finance be used by social movements? For instance, how effective is the responsible investment movement in changing corporate practice?
- Corporations vary with forms of financing—is this also true of social movements? Are both linked to varieties of capitalism?

FINANCE AND CULTURE

The effects of finance go deeper than simply changing how businesses work. In the United States, finance has become a worldview, a way of life. Polanyi (1944) defined the "commodity fiction" that accompanied industrialization: land and labor came to be treated as commodities produced for sale on a market. Similarly, Davis (2009a) describes the "capital fiction" in which categories of social life are regarded as forms of capital. Education and talent are considered as "human capital," and friends, families, and communities become "social capital," each category of assets suitable for investment or divestment. When more than half of all households are invested in the stock market, the investment metaphor transfers readily and is reinforced by the pervasive availability of information on how the market is doing. An example of this is perceptions of political interest. Nessler, Natalie and Davis (2012) found that stockholders came to identify themselves as Republicans to a far greater extent than did nonstockholders in the early 2000s, and this effect persisted through the 2008 election even though the market had collapsed. It appeared that "stockholder" was not just a simple pecuniary interest, but had become a core aspect of their identity.

Key research questions on finance and culture include:

- How does ownership affect identity and interests? How can this question be researched in ways that overcome endogeneity? For instance, could one construct an experiment to see how financial interests influence individual cognitions and political perceptions?
- How did the "capital" metaphor come to spread so widely? Do aspects of this metaphor also diffuse—for instance, do people purposefully invest and divest in their "social capital" in ways that follow investment nostrums?
- How does the extreme compensation in financial industries shape educational choices and pathways to mobility?

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Suntae Kim is a PhD candidate in Management & Organizations at the University Michigan's Ross School of Business. His research focuses on how alternative forms of organizing emerge to increase organizational diversity of modern economy, and the technological/cultural factors involved in this process. In this context, he is also interested in the micro-level process of the macro change, with a specific focus on noncognitive processes such as bodily and emotional feelings. His research on embodied cognition and creativity was published in *Psychological Science*, and his preliminary study on the emergence of Certified B Corporations was presented in the 2012 annual meeting of *American Sociological Association*. For his dissertation, Suntae is currently conducting an ethnographic field research in metro Detroit area to see how diverse social/economic experiments of alternative organizing are paving a way to the revitalization of the region. Before pursuing a doctoral degree at Michigan, he received his Bachelor and Master's degree in Business Administration from Seoul National University in South Korea. He also participated in the incubating process of a social enterprise, Orgdot, which won the finalist of Asian Social Venture Competition in 2009. When he does not ponder on the future of organizations and society, he spends most of his time carefully observing the developmental process of Eleanor, his one-year-old daughter.

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