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The impact of financialization on management and employment outcomes

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The Impact of Financialization on Management and Employment Outcomes

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ABSTRACT

This paper examines three questions: 1) How and why have financial models of doing business emerged in the last three decades? 2) What new forms of financial capitalism have become important in the current period? 3) How do new financial intermediaries, such as private equity, and the financial strategies of nonfinancial corporations affect the management of companies and employment outcomes? The paper describes how deregulation and institutional change created the conditions for a new, more powerful role for finance capital in the governance of U.S. companies, and it synthesizes the empirical evidence on the process and outcomes of financialization in large publicly traded corporations, as well as those taken over by private equity. Areas for future research are identified to examine how financialization affects management and employment relations in the postcrisis period.

JEL Classification Codes: D2, G3, J5, N2, P1

Key Words: United States, financialization, market deregulation, institutional change, private equity, institutional investors, management and labor relations

The Impact of Financialization on Management and Employment Outcomes

In the field of labor and employment relations, scholars have focused on product and labor market forces and institutions to explain variation in management strategies and employment outcomes. Particularly important have been the rules of industrial relations systems and how they shape and constrain managerial prerogative and the relative power of unions to bargain contracts that determine human resource practices. In addition, the field has paid close attention to the changing nature of technologies and rules governing product markets—factors that influence the relative bargaining power of capital and labor. As a result, in recent decades we have come to understand how the deregulation of labor markets, the declining power of unions, and the deregulation and globalization of product markets have shifted the balance of power from labor to capital, leading in turn to wage stagnation, increasing income inequality, and a deterioration in the quality of jobs for many working people.

The field largely has failed, however, to pay serious attention to the ways in which changes in financial markets and institutions also have influenced the relationship between management and labor and labor market outcomes more generally. These changes—which have been referred to as *financialization*, or the rise of financial capitalism—have altered the behavior of investors and introduced new models for doing business in the current economy. Financialization refers to a shift from managerial capitalism, in which the returns on investments derive from the value created by productive enterprises, to a new form of *financial capitalism*, where companies are viewed as assets to be bought and sold and as vehicles for maximizing profits through financial strategies.

The purpose of this paper is to examine these changes in financial markets and in the financialization of nonfinancial firms and to assess the implications for management and

employment outcomes. We focus on three questions: 1) How and why have financial models of doing business emerged in the last three decades? 2) What are the emerging forms of financial capitalism that have become important in the current period? 3) What are the specific mechanisms through which new financial intermediaries and the financial strategies of nonfinancial corporations affect the management of firms and employment outcomes?

The paper begins by defining the concept of financialization and then turns to a brief overview of the factors that led to the unraveling of managerial capitalism from the 1950s on. These include regulatory changes that deregulated the financial services industry and altered corporate and tax laws in ways that allowed large pools of capital to accumulate and move more freely and allowed new, unregulated financial instruments and intermediaries to emerge. These were complemented by fundamental shifts in the structure of power and decision making in large corporations. We then turn to the pivotal decade of the 1980s, when new models of financial engineering and leveraged buyouts emerged, and to the 1990s, when the lessons of the 1980s were diffused through the economy more generally and became institutionalized. The third section examines the different forms of financial business models in the 2000s, comparing the financial strategies of the private equity business model with those of publicly traded firms. While they share certain features, they also have unique opportunities given their different structures and strategies. We conclude by raising the critical question for scholars of management and employment relations: What are the key avenues of research that need to be pursued in order to advance our understanding of financial capitalism and advance public policy debates.

WHAT IS FINANCIALIZATION?

The concept of financialization is increasingly used to capture the idea that a fundamental shift has occurred in the character of capitalist activity over the last few decades. Central to this idea is that capitalist firms used to make money by producing or trading goods and services, but increasingly their profits depend on financial activities (Arrighi 1994; Epstein 2005; Palley 2007; Krippner 2011). Under managerial capitalism, which emerged as a business model in the first half of the 20th century, returns on investment were based on the value created by productive enterprises. Since the late 1970s, a system of financial capitalism has emerged in which companies are viewed as assets to be bought and sold and vehicles for maximizing profits through financial strategies. These financial strategies include trading, buying and selling companies or divisions of companies, selling off assets, using debt for tax advantages, or share price manipulation—strategies for making profits without regard to the effects on organizational productivity, quality, innovation, employment, or long-term competitiveness.

Efforts to measure the extent of financialization that has occurred have focused on the growing size of the financial sector and the proportion of profits in the economy that are due to financial activities. For example, the financial sector has captured a growing share of corporate profits in both the United States and Europe—growing from 25.7 percent to 43 percent in the United States between 1973 and 2005 (Palley 2007, p. 36), and from 21 percent to 36 percent of EU-15 countries between 1970 and 2005 (Watt and Galgóczi 2009, p. 192). Krippner (2011) provides two different estimates of the relationship between the financial and nonfinancial sectors: one based on the profit ratio and the other on cash flow. She argues that pure profit measures overstate the growth of the financial sector relative to the nonfinancial sector while cash flow measures (which include depreciation allowances) do the opposite. Her analysis of

these two measures brackets the range of possible change.¹ She finds that both measures remained relatively stable in the 1950s and 1960s and increased modestly in the 1970s (with the ratio of profits at a somewhat higher level). Both increased sharply in the 1980s, declined somewhat in the early 1990s, and then surged in the late 1990s. By 2001, the ratios (depending on which one is used) were three to five times higher than in the 1950s and 1960s (Krippner 2011, p. 40).

A second measure of financialization examines nonfinancial firms alone and estimates the relative proportion of revenue that comes from financial activities compared to productive activities. Krippner measures financial activities in nonfinancial firms as the ratio of portfolio income (dividends, capital gains, interest payments) to corporate cash flow. She finds that this ratio remained stable in the 1950s and 1960s at less than 10 percent; rose to approximately 20 percent by 1980 and 40 percent by 1989, before falling off and then stabilizing in 2000 at about 40 percent (2011, p. 36). Another measure—the ratio of net acquisition of financial assets to tangible assets in nonfinancial firms—also supports the idea of increased financialization, especially after 1980. The ratio was relatively stable at 40 percent or less till 1980, when it rose dramatically to about 100 percent in 2000 (2011, p. 39).

These indicators provide substantial evidence that a process of financialization is under way and that it particularly took off in the 1980s. The process can be seen in both the growing dominance of the financial sector in the economy as a whole and the growing importance of

¹ Profits alone are not an accurate measure because in any given year, the total capital available to nonfinancial firms includes profits subject to taxes plus depreciation allowances (which may be considerable in capital intensive industries). This measure, then, overstates the growth of financial firms (which have little depreciation) relative to nonfinancial firms. Cash flow data partially corrects for this, but may inflate estimates of profits in manufacturing industries. In addition, depreciation allowances have become more liberal over time, so these changes need to be taken into account (Krippner 2011, pp. 34–35, 39–40).

financial activities in nonfinancial firms. These figures do not, however, capture the interaction between the financial and nonfinancial actors in the real economy.

At the organizational level, financialization entails the process by which external financial actors—Wall Street analysts, investment banks, large investors and shareholders—are able to influence or control the internal organizational strategies and financial outcomes of nonfinancial firms. In this sense, the financial sector has become a primary governance agent and organizer of the real economy. Central to this mode of governance is the development of new financial instruments (e.g., junk bonds and commercial mortgage-backed securities), and new financial intermediaries, such as hedge funds and private equity funds that make capital highly mobile and available to quickly buy and sell companies or their assets. Hence, the idea of a “market for corporate control” emerged in the 1970s and 1980s (Lazonick 1992). If a company’s stock is undervalued relative to its assets, it may be easily bought, reorganized, and the underperforming parts resold, with the market the final arbiter of value.

The significance of capital mobility extends beyond the fact that companies are “bundles of assets” that may be bought and sold. From a strategic perspective, it also means that companies no longer need to commit themselves to competing in any particular product market. If the competition is too steep, they can get out. This resonates with Hirschman’s (1970) classic theory of exit, voice, and loyalty. In his analysis, dissatisfied customers can voice their discontent or exit. Dissatisfied workers can exercise voice through collective action or find another job. In the current period, companies can exit product markets they don’t like or that are too competitive. This differs from the past, when investments in plant and equipment tied up capital in fixed investments, and managers had to figure out ways to improve productivity, quality, and innovation in order to compete. Jack Welch developed this approach as CEO of

General Electric in the early 1980s. “If a business wasn’t first or second in its industry or didn’t have a good chance of getting there, Welch unloaded it. This knocked GE for a loop.”

(Lowenstein 2004, p. 55). Lazonick (2009) has noted a related phenomenon—financial models of firms lead managers who want to avoid a takeover to focus on stock price and use retained earnings for stock buybacks rather than investments in R&D, innovation, and worker skills. In addition, the easy exit strategy provides another reason why firms may reduce their commitment to invest in R&D for long-term growth and development. Businesses following a financial business model may find it easier and more profitable to exit a competitive product market than to invest in the kinds of innovations needed to compete effectively in a tough global economy.

Once capital investments are viewed as relatively liquid, rather than fixed assets, employees also become disposable. The idea of labor as a quasi-fixed asset (Oi 1962), or human capital as valuable and firm specific (Becker 1964) becomes obsolete as well. Labor returns to its status as a variable cost to be minimized. Because firms increasingly make profits from financial activities, and their success depends less on productive activities, their welfare is less intertwined with the welfare of employees. The decoupling of this relationship, due to the high mobility of capital, unravels the incentives that management traditionally had for investing in labor skills and engaging in productive labor-management relations.

INSTITUTIONAL CHANGE AND THE EMERGENCE OF FINANCIAL CAPITALISM

A series of institutional changes occurred in the United States from the 1950s on that dismantled the system of managerial capitalism that had emerged over the prior 50 years and allowed a new system of financial capitalism to emerge. Those changes were both regulatory and

organizational: Legal changes altered the external environment in which firms operated, and internal organizational shifts wrought new approaches to corporate decision making.

The Decline of Managerial Capitalism

The system of managerial capitalism depended on the market stability created by securities laws, put in place during the New Deal, which limited speculative behavior. The structure of decision-making and successful growth of large corporations depended on the separation of ownership and managerial control, which had emerged as an effective model in the railroad industry in the 1920s (Chandler 1954). Because ownership shares were widely dispersed, shareholders had little influence over decision making—a division that Berle and Means (1932) and more recently agency theorists (Jensen and Meckling 1976) decried as allowing managers to ignore the interests of shareholders.

Business historians, however, have shown how this separation of ownership and control enabled managers to direct the accumulation of capital and use retained earnings for investments in technology, machinery, skills, and R&D, or for the strategic acquisition of other companies. Corporations hired and internally trained and developed professional managers and experts to develop new products and processes, enhance corporate growth, and expand market share. Managers were loyal to the organization and were motivated to improve firm performance because human resource practices, or internal labor markets, provided opportunities for promotion, income growth, status, and long organizational careers. In the process, they created large-scale production facilities and mass distribution of goods and services to a growing middle class. Shareholders profited from a steady stream of dividends (Chandler 1977; Lazonick 1992), and workers benefited from rising wages that supported the growth of mass consumption (Palley 2007).

This argument is not meant to paint the managerial business model as ideal, as large corporations faced their share of opportunistic managers and labor-management conflict. In the postwar period, however, employers largely abided by labor laws, if grudgingly, and union contracts linked wage growth to productivity growth, fueling demand for mass-produced goods. Large nonunion corporations imitated the employment practices of union firms to avoid unionization (Kochan, Katz, and McKersie 1986). Relative prices tracked productivity gains, falling in industries where productivity rose (Appelbaum and Schettkat 1995). As a result, employees and consumers shared in the gains from productivity growth (Chandler 1990; Davis 2009; Lazonick 1992). At the same time, primary service industries such as banking, telecommunications, airlines, transportation, health care, and education were highly regulated, producing wide distribution of basic services; service labor markets were mainly local and shielded from broader competition.

The dismantling of managerial capitalism began with the rise of the diversified conglomerate in the 1950s and lasted through 1970s. The diversified conglomerate as a business model grew in response to Congressional passage of the 1950 Celler-Kefauver Act—an antitrust law designed to limit corporate monopolies that occurred when companies bought out their competitors (horizontal mergers and acquisitions), suppliers, or customers (vertical integration). Corporations responded to the Celler-Kefauver law by diversifying into unrelated businesses, leading to the emergence of very large conglomerates that controlled companies' portfolios. The development of portfolio theory in the context of financial assets justified this development, but it undermined the managerial model in several ways. Managerial opportunism was easier in these sprawling organizations, and financial performance did decline. Measures of product-specific divisional performance gave way to managing by the numbers (Lazonick 1992, p. 177), and

financial numbers were the ones that were comparable across radically different lines of business. Moreover, the frequent buying and selling of companies created a new norm of viewing companies as assets to be bought and sold. These developments undermined the power of line managers to make strategic decisions and build productive organizations while shifting power to chief financial officers (CFOs) who could manage the numbers (Fligstein 1990; Hayes and Abernathy 1980).

Emergence of a New Financial Business Model

By the end of the 1970s, a decade of recession and inflation, the rise of Japanese competitors, and poor performance made conglomerates vulnerable to hostile takeover bids. While not all conglomerates were poor performing, most were viewed as having excess cash on hand and poor corporate governance practices that had allowed CEOs to be complacent and take advantage of perks and a privileged lifestyle (Lowenstein 2004; pp. 6–7). For large corporations, the cash reserves kept the cost of capital low for investing in new products and processes, but corporate raiders sought to “disgorge the cash” (Jensen 1986, p. 323) and return it to shareholders. As Lazonick articulates (1992, pp. 167–168), the conflict was over the control of retained earnings: Strategic managers wanted a low dividend/earnings ratio in order to finance internal investments, while shareholders wanted a high dividend/earnings ratio for higher returns.

At the same time, a series of regulatory changes freed up large pools of capital for investment in the stock market and fueled the rise of pools of private capital available to new financial intermediaries. This included pension legislation that for the first time allowed pension funds and insurance companies to hold shares of stock and high risk bonds in their portfolios (Employment Retirement Income Security Acts [ERISA] of 1974 and 1978). Based on modern portfolio theory, ERISA and Labor Department regulations governing this act substituted the

“prudent investor rule” for the “prudent man rule.” Under ERISA, the fiduciary must make a determination that the investment is prudent as part of the portfolio of the pension plan, taking into consideration the diversification, liquidity, and projected return of the portfolio. The fiduciary’s investment decisions in individual assets are evaluated not in isolation but in the context of the portfolio as a whole (Federal Deposit Insurance Corporation 2005). This enabled pension funds to invest in riskier assets.

Similarly, Reagan-era policies facilitated the mobility of capital and the break-up of conglomerates. The U.S. Supreme Court overturned state antitakeover laws, which allowed corporate raiders more opportunities (Jarrell 1983). The Federal Trade Commission made it easier to undertake horizontal mergers so laws no longer favored the acquisition of companies across diverse industries. These changes also facilitated the rise of the market for corporate control—that is, the market for external actors to buy enough shares of publicly traded stock to take control of a corporation—which could occur through hostile takeovers or through “tender offers,” in which investors bypassed the CEO and boards of directors and went directly to shareholders to buy their stock at a higher-than-market price (Baker and Smith 1998, p. 18).

In addition, in 1982 Congress passed legislation allowing Savings and Loan banks (S&Ls) to make commercial loans (the Garn-St. Germain Act of 1982). This opened the door for investment in risky commercial activities, including junk bonds. High-risk bonds are rated by credit rating agencies as below investment grade because they have a higher likelihood of default (while yielding higher returns). They are more speculative in nature, and hence junk bonds. These legislative and judicial changes led to the emergence of large pools of liquid capital for junk bonds, which facilitated leveraged buyouts and the purchase of large blocks of shares of publicly traded companies by corporate raiders. Leveraged buyouts (LBOs) were used by

investors to acquire companies using a small amount of their own capital and borrowing the rest based on the assets of the acquired company, which were pledged as collateral. With a debt to equity ratio of 80/20 or higher, target companies saddled with this level of debt often experienced distress or went bankrupt.

The leading architect of the leveraged buyout model of the 80s was the firm of Kohlberg, Kravis, and Roberts (KKR). With its purchase of the Houdaille Corporation in 1979, it launched a model of financial engineering that became the dominant LBO model for the decade (Anders 2002; Baker and Smith 1998). A Fortune 500 company with 7,700 employees, Houdaille had lots of cash on hand, little debt, and was undervalued in the stock market. KKR put together a highly complex financial structure for the deal, which used very little of KKR's own capital and loaded the debt on Houdaille. Debt was critical to financial gains because it disciplined managers; and the retained earnings and tax savings from the increase in leverage and extensive use of tax arbitrage were used to service the debt (Baker and Smith 1998, p. 65ff).

Within a few years, the KKR model of leveraged buyouts gained legitimacy, and more and more investors and lenders participated. During the decade, almost half of all US public corporations had a takeover attempt (Mitchell and Mulherin 1996). Twenty-nine percent (144) of Fortune 500 firms in 1980 were subject to hostile takeovers in the following decade, and 125 of the attempted takeovers were successful. Firms that were less likely to be takeover targets had high market-to-book ratios, high debt, and more institutional ownership; while companies with finance CEOs were more likely to be targets, and older companies were more likely to be hostile targets (Davis and Stout 1992, pp. 624–625). At the same time, acquisitions during the decade were primarily horizontal mergers. Among Fortune 500 firms, the total level of diversification

dropped by one-third between 1980 and 1990, and the level of unrelated diversification dropped by 44 percent (Davis, Diekmann, and Tinsley 1994, pp. 554–561).

While buyout firms provided the financial innovations, of particular importance was the growth of institutional shareholders, who were active participants in buyout funds (Useem 1996). Their overall share of ownership in the stock market almost doubled—from under 30 percent to over 50 percent—between 1980 and 1996 (Gompers and Metrick 2001). Donaldson (1994) argues that the rise of institutional shareholders was critical in shifting the balance of power in the 1980s from corporate stakeholders to shareholders. In addition, the junk bond market expanded during the decade, providing easy money for buyout targets. This source of debt financing for acquisitions became increasingly common—a practice that soon led to the rash of bankruptcies by the late 1980s.

The model was further legitimated by academic theorists. Agency theory emerged as the dominant theory that provided overarching justification for a shift to maximizing shareholder value as the exclusive goal of the corporation and provided the rationale for leveraged buyouts. In this view, the principal cause of the low profitability of firms was the principal-agent problem. Opportunistic managers (the agents) with control over decision making were able to make decisions that favored their own interests at the expense of shareholders (the principals) because they were dispersed and unable to sufficiently monitor or control managerial power (Jensen 1986; Jensen and Meckling 1976). When investment and other spending decisions are financed out of retained earnings, managerial decisions are not subject to a market test of whether they are, in fact, the best use of these funds. Managers, not markets, allocate capital (see Lazonick and O’Sullivan 2000, pp. 13–35).

Agency theory argues that it is more appropriate for managers—especially those in mature firms in low-growth industries—to return free cash flow to investors and shareholders through share buy-backs and dividends and to use debt to finance new investment (Jensen and Meckling 1976). This approach subjects investment projects to scrutiny by financial firms and to a market test for efficiency (Kaufman and Englander 1993). Mature firms in particular are likely to have accumulated assets that can be used as collateral when they borrow, and their high free-cash flow can repay the debt without creating financial distress. Moreover, the necessity to repay debt keeps managers focused on maximizing shareholder value (Jensen 1986, pp. 59-75).

To curb managerial opportunism, agency theory suggested that shareholders needed to take a more active role. Corporate raiders could do this by purchasing the undervalued stock of companies. A small group of new owners could unseat the CEO and corporate board and insist on selling nonprofitable divisions or changing the strategic direction of the company. They could purchase companies through leveraged buyouts that loaded the companies with debt, which then subjected managers to the discipline of the market. Managers would need to use retained earnings to pay down the debt, and if they needed credit for investment, their decisions about the use of funds would be subject to a market test.

Note that agency theory also provided justification for attacks on trade unions, which were viewed as purely rent-seeking agents of workers and an obstacle to maximizing shareholder returns. Apart from a handful of labor-management partnerships in some industries, corporate attacks on unions and concessionary bargaining accelerated in the 1980s, encouraged by Reagan's firing of the Professional Air Traffic Controllers Organization in 1981.

In addition, new theories of compensation were a handmaiden to agency theory. To make managers think and act like owners, one had to turn them into owners. Theories of pay-for-

performance and awarding of generous stock options emerged in the 1980s and became dominant in the 1990s as the preferred approach in economics and strategic human resource management (Jensen and Murphy 1990).

Finally, while agency theory and compensation theory addressed the financial alignment of shareholder and managerial interests, they did not deal with organizational strategy. The theory of competitive advantage, advanced by strategic management scholars, provided a rationale and set of guidelines for organizational restructuring that was consistent with maximizing shareholder value. Prahalad and Hamel (1990) argue that firms could best compete in global markets by focusing on their core competencies and eliminating other lines of business. This was a direct attack on diversified conglomerates, many of which had performed poorly in the 1970s and 1980s. By focusing resources and talent with laser-like precision on a core business, undistracted by other product lines, companies could be best in class. While the gist of the argument did not focus on maximizing shareholder value, it nonetheless dovetailed nicely with agency theory: Selling off noncore—typically the less profitable divisions—provided immediate cash flow to shareholders while also subjecting the remaining core to more transparent shareholder scrutiny. The approach became justified in strategic management as a theory of competitive advantage in response to globalization of product markets.

In sum, the interaction of changes in financial regulations, new forms of financial engineering, the rise of institutional investors, and the theories of activist academics led to the emergence of a new business model for the American corporation—one based far more on financial strategies than productive ones. By the end of the decade, U.S. corporations had restructured into substantially leaner, focused firms designed to deliver high stock prices to shareholders.

Institutionalization of the Financial Model

As companies acquired in leveraged buyouts and saddled with high debt burdens filed for bankruptcy in record numbers by the early 1990s, the leveraged buyout model of the 1980s itself was discredited and viewed as dead, but many other trends continued. Despite the widespread fraud and bankruptcies of the period; for example, U.S. regulators continued to deregulate banking in a series of laws that repealed the Glass-Steagall Act of 1933—the law that separated commercial and investment banks in order to reduce speculative behavior following the Great Depression. These actions culminated in the 1999 Gramm-Leach-Bliley Act (GLBA), which allowed commercial banks, investment banks, securities firms, and insurance companies to consolidate. This provided nonbank financial institutions with access to insured deposits at commercial banks and dramatically increased the pools of liquid capital available for trading and speculation. The financial industry also created new complex financial instruments—commercial mortgage-backed securities used to securitize the debt, collateralized debt obligations, credit default swaps, and other derivatives—which were unregulated and became useful tools for financial engineering in the 1990s and 2000s.

The successful financial strategies of the 1980s also continued or were modified in the 1990s and became institutionalized. The junk bond market, for example, soon returned. The use of junk bonds declined in the 1980s with the credit crunch, but returned to 1980s levels by the late 1990s (Holmstrom and Kaplan 2001, p. 125). Large corporations incorporated market discipline into their organizational practices through performance management and compensation programs that linked managerial pay to the extent to which returns on capital exceeded the cost of capital, thus focusing managerial attention on this cost. Board vigilance increased, and institutional investors exerted more shareholder pressure, in part due to the

relaxation of SEC rules in 1992 that substantially reduced the cost to shareholders of mounting proxy contests that challenge management teams (Holmstrom and Kaplan 2001, p. 132–134).

Particularly important was the dramatic rise in use of stock options that tied CEOs to Wall Street. Legitimized by their growing use in Silicon Valley and by Jensen and Murphy's influential article on executive pay in the *Harvard Business Review*, their use took off after 1990 (Lowenstein 2004, pp. 17–19). Academic justification for stock option pay is that it helped solve the principal-agent problem by aligning the interests of top management and shareholders so that managers would make decisions to maximize corporate performance. The logical flaw in the academic theory, however, is that unlike shareholders, top managers did not invest their own money—there was no downside risk. In addition, the only metric used to measure corporate performance was share price. Other indicators that were important under managerial capitalism and are particularly important in tough global markets—productivity, quality, innovation, market share, sustainability—were secondary. Stock option pay did realign the interests of managers, from their commitment and loyalty to organizational performance and sustainability to a commitment to managing share price to maximize their personal wealth as shareholders (Lazonick 1992, p. 175).

Stock option pay, which began in the 1950s (Lazonick 1992, p. 172), stood at 20 percent of CEO compensation in 1980, but 50 percent in 1994; this represented a tenfold increase in the sensitivity of CEO pay to performance (Hall and Liebman 1998). This heightened sensitivity to the creation of shareholder value led to the increased use of derivatives and a variety of accounting and off-balance sheet practices designed to obscure the real financial volatility of companies and manipulate earnings reports and share price—practices that in the extreme were fraudulent and brought another round of scandals by early 2000s with the downfall of global

corporations such as Tyco, Global Crossing, Enron, WorldCom, and consulting firm Arthur Anderson (Lowenstein 2004). The financial engineering of the bankrupt companies threw thousands of people out of work while destroying their pensions as well.

In sum, the innovations by LBO investors in the 1980s became diffused throughout U.S. corporations in the 1990s as they embraced shareholder value as the single most performance metric, leading Steven Kaplan to write, “We are all Henry Kravis now” (1997). These innovations all contributed to the increased mobility of capital to quickly move in and out of investments. More generally, broader interest in the stock market as the single indicator of a strong economy grew. By the mid-1990s, about half of Americans owned stock, in part due to the spread of 401(k) retirement plans that were made possible through legislative changes in the early 1990s. Reflecting these trends, the media’s coverage of the stock market also radically increased, thus diffusing the discourse of shareholder capitalism throughout the economy (Lowenstein 2004, pp. 22–24).

GROWTH OF FINANCIALIZATION IN THE 2000S

With the new round of financial scandals in the early 2000s, Congress sought to reign in the worst excesses of earnings manipulation and fraudulent accounting behavior with the passage of the Sarbanes-Oxley Act in 2002. The law strengthened corporate governance rules, for example, by increasing the responsibilities of audit committees of boards, requiring CEOs and CFOs to swear to the accuracy of their financial statements, and prohibiting auditors from involvement in consulting activities for their clients. The New York Stock Exchange also changed its rules to require more independence of directors and subjecting stock-option plans to shareholder votes (Lowenstein 2004, pp. 205–207).

At the same time, however, despite the financial scandals, dot.com bust, and the recession of 2001, the ongoing trend in financial deregulation—designed to increase the mobility of capital—continued. Under the 2000 Commodity Futures Modernization Act, for example, Congress (at the request of the Clinton administration) explicitly excluded from regulation complex financial instruments such as derivatives and credit default swaps that lacked transparency and had been tools for accounting fraud. And in 2004, the SEC allowed investment banks to hold even less capital in reserve, thereby facilitating greater use of leverage in trading activities.

In the 2000s, the on-going effects of financial deregulation and liberalization on firm behavior manifested themselves in two ways. First, many large corporations had become adept at using a variety of financial strategies to make money and had reduced their dependence on productive activities. Second, large pools of unregulated capital had emerged in the form of hedge funds and private equity funds that allowed financial engineering and the shareholder model to be taken to new levels. While these two examples have a number of things in common in their use of financial strategies, they also are different in fundamental ways. In particular, large corporations continue to rely on stock price manipulation to maximize shareholder returns. By contrast, the private equity business strategy resuscitates the LBO model of the 1980s by making extensive use of debt leveraged on the acquired companies to buy out publicly traded companies and take them private (or using debt to buy out independent companies and keep them private). Stock price strategies are irrelevant. Rather, in the case of private equity, external investors intervene directly in the internal operations of their portfolio firms and exercise a more direct form of shareholder activism than that found in large publicly traded corporations.

Publicly Traded Firms: Downsizing, Outsourcing, Offshoring, and Stock Buybacks

In the 2000s, publicly traded companies expanded their use of stock option pay for top management, linking their personal interests more tightly to those of shareholders. An important mechanism for stock price manipulation is the use of stock repurchases by companies and top managers, which Lazonick (2011) describes as becoming “systemic and massive” since the 1980s, when the Securities and Exchange Commission loosened the rules on stock repurchases. Because so much of executive compensation comes from stock options, top executives have a strong incentive to take steps to increase their company’s stock price, and stock buybacks provide an easy tool to do so. Lazonick examines stock buybacks in the 292 companies of the S&P 500 that existed in both 1981 and 2007. In 1981, stock buybacks represented 3.6 percent of corporate net income in this sample of companies, while in 2007 they represented 89 percent (Lazonick 2011, p. 19). Stock buybacks, in turn, mean less investment in innovation and job creation.

Lazonick (2009) points to this mechanism as a major force undermining the competitiveness of U.S. industry in a global economy in which competitiveness depends on massive investment in R&D, process innovations, and knowledge-intensive products and services. Importantly, he finds that the use of stock buybacks, which had been concentrated in traditional large corporations in the 1990s, spread to leading ICT corporations in the 2000s—those firms that have led the ICT revolution and been the source of U.S. competitiveness and innovation over the last two decades. In the 2000s, companies such as Microsoft, Cisco, Intel, Oracle, Texas Instruments, IBM, HP, and Dell had stock repurchase payouts that exceeded their investments in R&D (p. 233).

Also notable among large publicly traded companies is the sharp rise in business strategies to cut costs via downsizing, outsourcing, and offshoring as a strategy to boost stock

prices. The extent of downsizing, outsourcing, and offshoring in public corporations over the last three decades has been well documented in the economics and labor relations literature. These practices largely have been attributed to the deregulation and the globalization of product markets, the intensification of competition, and the decline in the power of unions to influence corporate restructuring and mitigate job loss. While these explanations are important, the role of financialization in creating incentives for these practices has been less explored.

Financial approaches to business management are likely to exacerbate the use of downsizing, outsourcing, and offshoring, or to make these practices the first, rather than the last, resort for competing in global markets. In firms that focus on maximizing shareholder value above all, selling off less profitable businesses is a quick source of improving profit margins. The downsizing of existing operations via outsourcing and offshoring also provides a quick fix for cutting costs and boosting quarterly profits.

How has the focus on shareholder value and core competencies affected management and employment outcomes? Some recent research has documented the link between shareholder maximization strategies and employment loss in major S&P 500 corporations in the 1980s–2000s (Jung 2011). Using a continuous-time event history analysis of downsizing announcements by 681 large, publicly held companies between 1984 and 2006, Jung argues that firms, under pressure from powerful shareholder groups, have used downsizing as a strategy to increase share price. Another analysis of 95 of the largest U.S. corporations between 1996 and 2006 finds that those firms with finance-oriented CEOs and higher dividends per share were more likely to announce layoffs than other firms. In addition, corporations that announced more layoffs offered higher compensation to CEOs in subsequent years (Shin 2010). These studies incorporate a series of controls for industry market conditions and other measures of firm

characteristics and performance. They are suggestive, although it is somewhat difficult to separate the relative importance of shareholder pressures from real pressures facing firms in cost-competitive markets.

A second effect is the growth in the proportion of jobs that have relatively low wages and benefits. As large corporations have outsourced work to subcontractors, primarily as a way to either cut costs or avoid union contracts, low-wage employment has moved up the occupational scale and the proportion of low-wage jobs in industries has grown. Empirical research on in-house versus outsourced establishments providing similar services, for example, shows that the in-house call centers offer a significant wage premium over outsourced centers, even after controlling for the level of skills and task complexity of the work (Batt and Nohara 2009).

The vertical disintegration of firms and the growth of low-wage jobs in small subcontractors are also associated with rising wage inequality. The core competency theory of management suggests that firms should continue to refine a specialized division of labor, spread across different types of firms and networks of organizations. The premium jobs that remain in primary firms represent a much smaller share of jobs compared to a much larger pool of low-paid jobs in secondary firms and small independent organizations. Primary firms use subcontractors to cut costs and put pressure on those firms to deliver low-cost inputs, which in turn puts downward pressure on wages and benefits. Subcontractors also are less likely to be unionized or have the resources to pay wages comparable to primary firms. Davis and Cobb (2010) analyze time-series data from the United States since 1950 and from 53 countries around the world in 2006. They find that the higher the proportion of employment concentrated in large firms, the lower the income inequality. In other words, as firms vertically disintegrate, income inequality rises.

Maximizing shareholder value along the lines promoted by the core competency argument may also help explain what David Weil (2010) has referred to as the “fissurization” of the labor market (2010, p. 20-22). Weil argues that there has been an explosion in the use of franchise business models across many industries. This provides another vehicle for primary firms to maintain control over operations while shifting responsibility for labor and employment relations to franchisees, who typically offer worse pay, benefits, and working conditions. Moreover, the use of multiple tiers of ownership and subcontracting has created fragmented labor markets in which it is difficult or impossible to trace who is legally liable for employment decisions and contracts.

Maximizing shareholder value via core competency strategies also undergirds the strategy of offshoring work and the expansion of global value chains, according to the work of Milberg and Winkler (2009). Based on an analysis of 35 manufacturing and service industries for the 1996–2008 period, they show that multinational corporations have raised profit margins by offshoring work to lower-cost regions, which has allowed them to lower input prices and even increase cost markups, leading to higher profit rates. This represents a shift in the sources of profits—from domestic product markets to foreign input markets. During the same period, both employment and the labor share of national income in the United States were negatively associated with increased offshoring. This strategy also puts downward pressure on the wages and conditions of employment of U.S. workers (Milberg and Winkler 2009).

Supporting the link between financialization and offshoring, Krippner (2011) finds that between 1977 and 1999, the ratio of financial to nonfinancial profits earned abroad rose much more sharply than did the same ratio for domestic profits. While the ratio of profits earned abroad starts at a much lower level in 1997, it surpasses the ratio for domestic profits by the mid-

1990s. She finds a similar trend for nonfinancial firms alone. Between 1977 and 1999, the ratio of foreign-source portfolio income to cash flow rose sharply in the 1980s, leveled off in the early 1990s, and then skyrocketed by the end of the decade. By contrast the ratio of domestic portfolio income to cash flow grew only modestly. By 1999, the ratio for foreign income was twice the level as for domestic income, indicating a much stronger trend in financialization for offshoring activities (Krippner 2011, p. 48).

Importantly, however, the increased profits that multinational corporations have made abroad often have not been used to invest in productive enterprises at home. The U.S. tax code allows corporations to defer taxes on corporate profits held abroad, which has led many corporations to continue to hold those profits in foreign accounts rather than reinvest them at home. In 2011, U.S. business corporations held an estimated \$1.4 billion in offshore accounts (Lazonick 2011, p. 28). In addition, when profits are repatriated, firms have often used these higher profits to repurchase their own stock in order to boost prices. This pattern has been well documented by Lazonick, who refers to this type of financial business model as one of creating “. . . profits for the sake of higher stock prices rather than creating the high value-added jobs that are the essence of a prosperous economy” (Lazonick 2011, p. 9).

New financial intermediaries: Private equity in the 2000s

Private equity, which emerged as a major source of unregulated, private investment in the late 1990s, represents another approach to the financialization of firms. Its explosive growth in the 2000s took many by surprise. By 2011, they managed roughly \$1.3 trillion in funds and, with leverage, they controlled an investment portfolio that is several times the base capital (Wharton Private Equity 2011). According to one estimate, there are roughly 2,300 private equity firms in the United States, with financial control over 14,200 U.S. companies that employ 8.1 million

people (Private Equity Growth Capital Council 2011) – a number slightly higher than the number of union members in the entire U.S. private sector.

Private equity organizes its funds as separate business entities, and most of these funds as well as most hedge funds have avoided regulatory oversight by the SEC because their small size has exempted them from reporting requirements of national securities laws. This has allowed them, in contrast to mutual funds for example, to engage in financial practices such as making use of substantial leverage, selling securities short, and adopting performance-based fees that increase with fund gains but do not necessarily decrease with losses. The funds operate with little transparency (even to their investors) and without board oversight (Fruhan 2010, p. 10). As of 2012, however, funds with more than \$150 million in assets are required to register with the SEC and abide by basic reporting requirements in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011. Reporting requirements include basic organizational and operational information on each fund managed by a private equity firm, the size and ownership of each fund, nature of services, types of clients, employees, advisory and nonadvisory activities, and potential conflicts of interest (Federal Register 2011; PriceWaterhouseCoopers 2011). While the industry claims that these rules are overly burdensome, it appears they will not alter their business model.

Private equity and hedge funds also benefit from U.S. tax laws, which define their earnings as carried interest rather than performance-based pay. This allows their earnings to be taxed as capital gains (currently at a 15 percent tax rate), rather than at the corporate or ordinary income rate (as high as 35 percent) (Fleischer 2008; GAO 2008, p. 72; Marples 2008). In addition, most private equity and hedge funds register offshore in order to avoid other tax requirements. They use the offshore fund for certain U.S. tax exempt investors and for non-U.S.

investors (Jickling and Marples 2007, p. 6). Finally, U.S. tax laws provide incentives to use the leveraged buyout model because the interest on debt is subtracted from taxable income, whereas retained earnings or dividends are taxable as profit.

In the typical private equity business model, the private equity firm (the general partner) raises capital for a fund from large institutional investors or other wealthy individuals (the limited partners). The private equity firms typically buy out target companies and take them (or keep them) private, with the goal of improving financial performance and exiting the investment within five years. Each fund is a separate legal entity, so that deals made by one fund do not affect the firm's other funds. Each deal also creates a separate legal entity and is constructed using high leverage to purchase the company while using the assets of the company as collateral for debt and obligating the acquired company—not the private equity firm or the fund that acquired the company—to repay the debt. In a deal with 70 percent leverage, for example, most of the remaining 30 percent would be put up by the limited partners, with the private equity partners contributing a very small percentage (perhaps 2–3 percent of the equity). If a deal goes badly, the partners will lose their equity in that particular deal, but neither the private equity firm nor the investment fund is liable for any losses.

Private equity partners have two sources of pay. Traditionally they have collected a flat 2 percent annual management fee on all funds committed by the limited partners (20 percent of committed funds over the 10-year life of the investment fund), whether or not the funds have been invested.² Limited partners must keep these funds in liquid assets, available for when the private equity firm calls on them. The general partners in the fund also receive 20 percent of all investment profits once a hurdle rate of return has been achieved. This pay-for-performance

² In the postcrisis period, large LPs have been able to negotiate over management fees. It is not unusual for management fees to be set at 2 percent of total committed capital for the first 5 years and a lower percent in later years (Metrick and Yasuda 2009).

model has little downside risk, as the private equity partners are not liable for losses on investments that go sour; and while they put up a fraction of the at-risk equity in the deal, they collect 20 percent of the profits.

The multiple fund structure of PE firms also creates unique incentives to maximize shareholder returns over the entire set of portfolio companies in a fund and across funds, rather than maximizing returns for any one company in particular. That is, if one or two deals go poorly, they can be written off, given the number of other deals that the private equity firm is managing. Each portfolio company is part of a larger numbers game. Thus, private equity seeks to maximize overall returns to a fund's investors across all of its investments over a period of a few years, rather than maximizing the long-term competitiveness or sustainability of any individual operating company in its portfolio.

When private equity firms buy a target company, they have a number of ways to make money. First, they may improve operations by investing in new technologies or processes, expanding into new markets, closing less profitable establishments or divisions, or reducing labor costs via downsizing or wage or benefit reductions. Second, between the time of acquisition and exit, they may benefit from an increase in stock prices (due to operational improvements or to a generally rising stock market, as occurred in the 2000s). These two options are available to any firm.

Financial engineering strategies based on the use of very high leverage and aggressive tax arbitrage are more unique to private equity firms. For example, a study of 153 private equity buyouts between 1985 and 2006 showed that the private equity–owned firms had an average net debt to enterprise value level of 67 percent, compared to 14 percent for comparable publicly traded firms. Average net debt to EBITDA (earnings before interest, taxes, depreciation, and

amortization) was 5.4 percent in the buyouts and 1.1 percent in the public firms (Axelson et al. 2007, cited in Strömberg 2008, p. 7).

Purchasing companies using high leverage that is loaded on the acquired company allows private equity firms to make higher returns while reducing their risk. Debt disciplines managers to cut costs and increase revenues in order to service the debt. The interest on debt is also tax deductible, so that high use of leverage lowers taxes substantially. Private equity firms also frequently take out additional debt that is loaded on the company, in the form of high risk junk bonds, and pay themselves and their investors dividends (referred to as dividend recapitalizations) or by dipping into the company's cash flow. Private equity firms also can profit from selling off the real estate and other assets of the acquired company without regard to the effect of such actions on the long-term viability of the portfolio company.

The extensive use of debt magnifies returns when private equity successfully exits an investment, but it also raises the risk of financial distress or bankruptcy for the portfolio company that must service the debt. Asset stripping and the payment of dividends also make portfolio companies more vulnerable to failure. Thus, these financial strategies often undermine the long-term viability of the portfolio company.

How is this model different from past models in its effects on management and workers? First, because ownership is concentrated, private equity owners typically drive corporate strategy and decisions. Because the company is loaded with debt, managers are under intense pressure to produce high returns and cut costs. In the parlance of agency theory, managers are disciplined by the market: their time horizons are shorter, and they have significantly less discretion to use resources to invest in or manage their relations with labor, suppliers, or customers. Managers, who know their business and competitors well, may understand that these short-term measures

undermine the capacity for innovation and longer-term competitiveness, as well as relationships with employees, suppliers, and customers, but their power to influence decisions has shrunk. Moreover, private equity provides incentives to managers to focus on short-term returns through a form of pay-for-performance: by providing them with an opportunity to share generously in the upside returns if the private equity firm is able to exit the investment successfully.

In these circumstances, the strategies of new owners who are not familiar with the business may undermine implicit relations of trust (intentionally or unintentionally) upon which enterprises depend for long-term survival. The management literature has shown that trust-based relations, within and across organizations, are needed to achieve sustainable competitive advantage (Appelbaum, Gittell, and Leana 2008; Gittell, Seidner, and Wimbush 2010; Heckscher and Adler 2005). A case in point is the private equity leveraged buyout of Mervyn's department store by a private equity consortium led by Sun Capital in 2004. The chain depended on a decades-long relationship with a creditor in order to ensure regular shipments of merchandise from suppliers. When the new PE private equity owners took charge, they were unwilling to back the same relationship terms, and the creditor refused to front the necessary cash to suppliers. Mervyn's could not sufficiently replenish merchandise and sales plummeted (Appelbaum, Batt, and Clark forthcoming).

Second, these intense cost pressures also often lead to heightened job loss. Two comprehensive studies of the impact of private equity on employment find that overall job loss in private equity –owned firms was higher than in comparable publicly traded firms (Davis et al. 2008, 2011). A 2008 study examines 5,000 U.S. firms and 300,000 establishments to examine employment growth in target firms and establishments acquired by PE relative to employment growth in carefully matched controls in 1980–2006. The study finds that gross job creation was

equal in private equity–owned establishments and comparable non-private equity-owned establishments, but gross job destruction was much higher in the former, particularly in retail trade, services, and FIRE (finance, insurance, and real estate). On average, the two-year cumulative employment difference was 6.7 percent lower in private equity–owned establishments. This is offset somewhat by higher growth of jobs in private equity–owned greenfield sites (Davis et al. 2008). The second study, using the same data set but a smaller subset of firms and establishments, also finds greater job loss at private equity–owned establishments compared to the non-private equity-owned control group: 3 percent more after two years and 6 percent over five years. At the firm level, however, the researchers argue that the effects were smaller because PE-owned firms were more likely to open greenfield sites. However, as their results show, the effects of greenfield plants on employment in private equity–owned firms was relatively small. Rather, the private equity–owned firms gained jobs by acquiring other establishments (Davis et al. 2008, 2011). These jobs, of course, were not created by private equity and do not represent net new jobs in the economy. In sum, even the more positive study still finds substantially greater job loss (or slower job gains) in private equity–owned companies than in comparable non-private equity-owned public companies.

A third important difference between private equity–owned companies and comparable publicly traded companies is their higher risk of financial distress and bankruptcy. For example, a worldwide study comparing private equity–owned firms and comparable publicly traded firms between January 1970 and June 2007, prior to the global financial crisis, finds that the former had twice the level of bankruptcy rates as the latter—1.2 percent annually versus 0.6 percent (Strömberg 2008). Since 2007, when firms faced the economic recession, bankruptcy rates have been much higher. For example, one study of highly leveraged firms (half of which were owned

by private equity), finds particularly high rates for 2007–2010, when the default rate for these firms increased to 25 percent (Hotchkiss, Smith, and Strömberg 2011).

In recent years, bankruptcies of prominent private equity–owned firms include NewPage Corporation (the largest bankruptcy in 2011); Simmons Mattress, Reader’s Digest, Friendly’s Ice Cream; Fortunoff Jewelers in New York City; Sbarro; Harry & David; Archway and Mother’s Cookie Company; Extended Stay Hotels; SSI Group, which operates Grandy’s and Souper Salad restaurants; and Real Mex, which operates El Torito Restaurant and Chevys Fresh Mex (Appelbaum and Batt 2012, p. 27–29). Some major retail chains were unable to emerge from bankruptcy and were liquidated, including Linens ’n Things, Mervyn’s department store chain, and Anchor Blue clothing stores. Among the businesses purchased by private equity firm Bain Capital between 1984 and 1999, 22 percent either filed for bankruptcy reorganization or were liquidated by the end of the eighth year (12 percent by the end of the fifth year) following the investment (Maremont 2012). In addition, a large number of LBOs from the 2005–2007 period have large debt loads that private equity has been able to refinance, but their futures remain uncertain. Thousands of jobs have been lost in these bankruptcies. In a number of these cases, private equity firms also have turned over pension liabilities to the U.S. government–backed insurance program, Pension Benefits Guarantee Corporation, when their portfolio firms entered bankruptcy. This strategy enables the bankrupt company to offload its pension responsibilities, while retirees receive lower pension payouts.

The risk of bankruptcy is enhanced by a frequently used private equity strategy of splitting portfolio companies into two pieces: a property company, which owns the real estate and other assets, and an operating company. Private equity typically sells the property company and pockets the returns, guaranteeing its return on its initial investment regardless of how the

operating company performs, while requiring the operating company to pay rent for the real estate it previously owned. In retail, store ownership has historically protected businesses during downturns in the economy when cash flow falls. Returning to the Mervyn's example, after the private equity acquisition, the private equity owners immediately split the company in two and, after holding the properties long enough to obtain a tax advantage, sold them off to a real estate investment firm. Mervyn's stores were required to pay high rents to lease back the property—this in addition to the cost cutting strategies that had undermined employee and supplier relations. These and other strategies undermined Mervyn's capacity to compete, and it suffered a \$64 million loss in 2007, before the onset of recession. This was *less than the \$80 million annual increase* in its rent payments following the LBO. Mervyn's ended up in bankruptcy in 2008, and 18,000 employees lost their jobs (Appelbaum, Batt, and Clark forthcoming).

A fourth consideration is the effect of private equity on labor management relations and collective bargaining. Here, the U.S. evidence is equivocal. There is little evidence that American private equity owners are more hostile to labor unions than American corporations more generally. There are examples of small and large private equity firms that have negotiated contracts in good faith with unions (Croft 2009) and others in which their antiunion animus has led to serious labor law violations (Appelbaum and Batt 2012). A more serious concern is that even when private equity firms have negotiated union contracts, their overall business model is one of extracting wealth for shareholders and favors private equity owners over employees; further, the risky use of leverage puts the overall sustainability of the enterprise at risk. A good example is the 2007 private equity buyout of TXU, the Texas utility company now known as Energy Future Holdings—the largest private equity buyout in history—worth \$48 billion at the time of acquisition. The private equity consortium launched an inclusive stakeholder strategy

(and a \$17 million lobbying campaign) that brought together Texas politicians and environmental groups who backed the deal on the promise of the closure of coal-powered plants. It also negotiated a contract with the union (the International Brotherhood of Electrical Workers), which ensured union recognition and no job loss for three years (Beeferman 2009, Kosman 2009, pp. 10–11). Nonetheless, the enterprise was in financial distress as of 2012 because its business strategy failed. As of January 2012, it still held \$17.8 billion of an original debt of some \$40 billion. Credit default swap traders were betting a 91 percent chance that the company would not meet its financial obligations in the next three years (Childs and Johnsson 2012).

A final question is whether private equity funds fulfill their promise of paying higher returns to their investors. This is important because, like the leveraged buyouts of the 1980s, institutional investors, particularly large public pension funds, have played a critical role as key investors. In 2007, for example, the top four investors in private equity funds were CalPERS (California Public Employees' Retirement System), CalSTERS (California State Teachers' Retirement System), PSERS (Pennsylvania Public School Employees' Retirement System), and the Washington State Investment Board (Private Equity Analyst 2008, cited in Kaplan and Strömberg 2009). This involvement of workers' capital in private equity acquisitions has raised important dilemmas for these pension funds. While they invest in private equity in order to boost returns for their retirees, they are faced with numerous examples of private equity takeovers that have resulted in plant closings, layoffs of workers, and antiunion campaigns in portfolio companies.

It is noteworthy then that the available evidence is equivocal on whether private equity firms fulfill their promise of higher returns. Kaplan and Schoar (2005), for example, examine data for the 1980 to 2001 period and find that on average returns to private equity funds, net of

fees and the carried interest collected by the private equity firm, were slightly less than those of the S&P 500 index. They find that returns for funds whose performance places them in the top quarter of funds outpaced the market for publicly traded companies but the majority did not. The wide variability in the returns earned by these funds means that returns to limited partners frequently underperform the broad stock market. Other studies have reached similar conclusions (Higson 2010; Phalippou and Gottschalg 2009). More recently a *New York Times* analysis of public pension funds finds that pension funds with a higher proportion of investments in alternative funds (private equity, hedge funds, and real estate funds) had lower returns than those with less risky investments. Those funds that had a third to over half of their money in alternative investments paid almost four times more in management fees than did those funds that avoided these risky investments, and they had returns that were more than a percentage point lower on average than returns of funds that avoided these investments (Creswell 2012). Thus, the justification that private equity improves the retirement income for middle-class Americans is questionable.

IMPLICATIONS FOR RESEARCH AND CONCLUSIONS

Our analysis of the current research has identified some of the implications of financialization for the management of firms and the outcomes for employees and other stakeholders. The literature is suggestive of the kinds of problems linked to financialization and of the regulatory reforms that may be needed. But our theoretical and empirical understanding of financialization is at an early stage, and many unanswered questions remain.

Several questions need further investigation. First, we need a better understanding of the various ways in which different financial mechanisms extract wealth from firms. We have

highlighted the role of stock options, stock buybacks, aggressive tax avoidance strategies, high leverage, and asset stripping, but we need a finer-grained analysis of these and other mechanisms and their contingencies. How do differences in industry and market conditions alter the feasibility and payoffs to distinct financial strategies? How do different national regulations and institutions affect the feasibility of these strategies, the magnitude and distribution of wealth extraction, and other outcomes?

Similarly, we need to disaggregate different types of financial ownership and financial intermediaries. In this paper, we have compared examples from large publicly traded firms and private equity. This is only a starting point. For example, how do the mechanisms for value creation and extraction vary across different types of publicly traded companies and across different types of financial intermediaries: private equity, hedge funds, venture capital funds, and others? Or across companies in different market segments? How do they vary by industry or sector, and do they lead to different rates of productivity growth, bankruptcy, or profitability?

Second, and related, what is the relative importance of financial and productive sources of earnings in nonfinancial corporations, and how does this differ across distinct types of firms, sectors, and regulatory contexts? How are the two interrelated? Answering these questions requires an analysis of the ways in which financial processes are linked to labor processes. How does the structure of financing and ownership affect management decisions regarding business strategies, location of activities, and organizational restructuring? How does it affect the organization of work, investment in employee skills and development, and managerial discretion?

In this paper, we have largely portrayed financial and productive strategies for profit making as producing zero-sum outcomes: Financial strategies that use retained earnings for stock

buybacks rather than productive investment or those that sell off assets for short-term gains when those assets are needed for longer-term stability and growth. Of course, the outcomes depend upon the strategy, the context, and the sets of incentives driving economic behavior. Anecdotal evidence points to examples of private equity firms providing their portfolio firms with capital for technology, process improvements, or market expansion, or to gain access to financial expertise or economies of scale in purchasing or distribution. How widespread are these examples? Are they idiosyncratic and dependent upon the goodwill or ideological commitment of individual actors? Are they more common in smaller firms with smaller debt loads and with fewer assets that can be used as collateral? Or are they a response to a set of structured incentives? We need much more research to understand the factors that encourage productive investment behavior rather than financial engineering among new financial intermediaries.

Third, the theoretical explanations linking financial incentives and management decisions are poorly understood. Much of the argument points to the change in the alignment of incentive structures for top management so that their decisions respond to their own self-interest as shareholders rather than as long-term stewards of the companies they manage. But managers are subject to other external pressures as well. Under what conditions do managers retain independent scope of action that allows for longer time horizons or a consideration of broader stakeholder perspectives?

In the context of the sharp rise of pay-for-performance for managers, some research points to a concomitant rise in the callousness of managers' actions and behaviors—what Steve Greenhouse (2008) refers to as “the big squeeze”—as it ripples through organizational hierarchies. But is it possible to untangle the relative importance of simultaneous factors—global competition, deregulation, deunionization, in addition to shareholder demands—which have

intensified pressure on cost-cutting and lean organizations. Recent research provides some insights into this question. Desai, Brief, and George (2010), for example, draw on psychological, sociological, and economic theories of power to argue that the rise in CEO compensation leads to enhanced perceptions of power in organizations, which empirical research has shown is associated with lower empathy and more likelihood of objectifying and stereotyping others. Their data on 261 top U.S. corporations linked CEO compensation to the Kinder, Lydenberg, Domini & Co. (KLD) Company Profile data (which rates the employee relations policies of firms among other things). They find that the higher the compensation of a company's CEO, the poorer, or "meaner," the employee relations practices. The results of their laboratory experiment were consistent with this interpretation. This type of research can begin to unpack causal explanations.

Fourth, researchers in labor and employment relations need to address the question of sustainability and broaden the range of stakeholders included in our analyses. In the examples we have studied, suppliers, creditors, consumers, and homeowners have been adversely affected by the risky behavior of private equity firms. How much leverage is too much for sustainable enterprises? Under what conditions does financial capitalism create sustainable enterprises and stable jobs? Which workers win or lose, and are there changes in the level of inequality in wages and working conditions between more and less privileged or skilled occupational groups? Are different groups of stakeholders affected differently? Do consumers win or lose, and why?

Fifth, specific studies of the labor process in the financial industry itself are needed. Recent examples include workplace ethnographies that explain the social and psychological dynamics of investment banks and other financial services organizations that create perverse incentives for employees (Ho 2009; Zaloom 2006). These provide deeper insights into how and

why the financial industry has succeeded in creating the incentives that drive behavior and decisions that affect the nonfinancial sector.

In sum, recent research is advancing our understanding of financial capitalism and the ways in which it changes the nature of corporate governance and decision making, and in turn, management and employment practices, and the sustainability of enterprises. Much more work is needed, however, to build a solid theoretical foundation and provide the empirical evidence that will enable new policies and institutions to be devised that can curb the worst excesses of financial engineering and provide incentives for innovation and economic growth.

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