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Inequalities to the Beats of Financialization

by Olivier Godechot

Financialization pervades all spheres of the economy today, but it is not a uniform and monolithic phenomenon. We need to carefully distinguish the different mechanisms by which it is deployed, in order to understand how it produces social inequalities.

About: Ken-Hou Lin, Megan Tobias Neely, *Divested. Inequality in the Age of Finance*, New York, Oxford University Press, 2020.

In contrast to the classical analysis that makes the rise in contemporary inequalities primarily the result of biased technological progress (i.e. a type of economic growth where the demand for skilled labor increases faster than its supply), *Divested. Inequality in the Age of Finance* offers another explanation.[1] The increase in inequality is the result of the financialization of the economy, understood not only as a rapid growth in the activity of the financial sector but also as the result of a financial transformation of the income, investment, indebtedness and savings of the other actors in the economy, notably non-financial firms and households. Ken-Hou Lin and Megan Tobias Neely thus propose a coherent and inspiring synthesis of the work of the last fifteen years on financialization, while also adding new perspectives on some of its less studied dimensions such as student debt or the crisis of pension funds.

[1] This translation was edited by Allison Rovny.

A Synthesis on the Financialization of the United States

The book proposes to demonstrate the consubstantial relationship between the financialization of contemporary capitalism and the explosion of inequalities by taking the United States as an empirical example. It begins by presenting these two major transformations in the first two chapters, and continues with four chapters centered on different areas where the relationship is being established: the financial sector, non-financial firms, household debt and wealth. A final chapter deals with the changes following the 2008 financial crisis and its regulation. The book is clear and well-structured. It skillfully combines a historical analysis of institutional transformations with a statistical analysis rich in numerous graphs representing fifty years of evolution of the various indicators of financialization or inequality.

The end of the Bretton Woods system, which reactivated the foreign exchange market, and the crisis of the 1970s, which discredited Keynesian state regulation and favored deregulation, along with the liberal inflection of the 1980s, which put private enterprise and shareholders back at the center, have allowed the financialization of the economy. The dismantling of regulations resulting from the New Deal, far from benefiting consumers, favored on the contrary a commercial dismantling of banking services and a growing concentration of the sector: the share of assets of the three leading banks rose from 10 percent of banking assets in 1990 to 35 percent in 2007 (p. 62). Financialization is further broken down into four major trends: a) the increase of the financial sector in the value added of the economy (both in the form of profit and wages), b) the reorientation of non-financial firms towards financial activities, c) the submission of firms to the imperatives of shareholder value, and d) the expansion of debt, especially household debt. Lin and Tobias Neely systematically analyze the consequences for inequality in income distribution and wealth both across income groups and in terms of intersections between gender, parenthood, and ethno-racial background.

The book points out that the increase in inequality linked to financialization is primarily due to the fact that finance is a wage niche where very high wages are paid to a very small minority of Wall Street bankers, mainly white men. The structure of the financial wage rent is reversed. At the beginning of the 1970s, employees at the

bottom of the salary hierarchy benefited more strongly from a job in finance (+35% more salary compared to other sectors) than those at the top (+20%). On the contrary, a few decades later, employment in finance favors the top of the hierarchy (+60%) more than the bottom (10%).

Beyond the financial sector, non-financial companies mirrored the banking industry by not only increasing their financial revenues, but also notably by coupling, as in the automotive sector, the sale of goods with the distribution of credit. They have also increasingly subjected themselves to the imperatives of the "shareholder revolution." In the name of shareholder value creation, they have restructured their core business, outsourcing ancillary activities, relocating production to low-wage countries, eliminating social benefits, especially defined benefit pension plans, and trying to break unions' power. Even though salaried company executives could also have been weakened by the shareholders' return, the former were able to renew and strengthen their power by claiming to act on the latter's behalf. Thus, in the 1990s, the salaries of the 350 highest paid CEOs rose from $3 million to $20 million.

Debt is the main manifestation of household financialization. For a long time, the poorest U.S. households had little access to bank credit, which kept them in a poverty trap. The development of credit, supported by deregulation and securitization, could have led to greater financial inclusion and moderated inequalities. However, improved access to credit primarily benefited the middle classes, especially households between the 60th and 80th percentiles. The upper end of the distribution uses credit mainly for real estate acquisitions that are part of wealth, while the lower end of the distribution makes greater use of consumer credit, which is more expensive and does not allow for any wealth accumulation. The poorest fifth of households are then more often confronted (and increasingly so during the 2000s) with repayment incidents and over-indebtedness (p. 132). Their inclusion in U.S. credit schemes seems therefore costly, or at least less beneficial than for other income groups.

In addition to the inequalities between income groups in terms of access to credit and the constitution of wealth, the book also demonstrates the increase in wealth inequalities according to ethno-racial origin (p. 144) and above all the difference in destiny according to generations, linked to two deep crises for the U.S. society: the pension crisis and the student debt crisis. The proportion of employees benefiting from a pension plan decreased from 55% to 40% between 1980 and 2014 (p. 105). In addition, the transformation of defined benefit pension plans into defined contribution plans makes them more uncertain and generally less remunerative. Similarly, the

considerable increase in the cost of higher education has led to a very sharp rise in student debt, which is detrimental to asset building. At the age of 30-34, the cohort born between 1977 and 1982 has a wealth that is 20 percent (for the top 10 percent) to 80 percent (for the bottom quartile) lower than that of the cohort born between 1971 and 1976. And with good reason: they have to pay off heavier student loans for longer periods of time.

In the last chapter, the book examines the developments following the financial crisis. The Obama administration's attempts at regulation, largely dismantled by the Trump presidency, have hardly changed the picture. On the contrary, inequalities increased after the financial crisis. The authors conclude the book with a few proposals for transforming the industry and plead in particular for the deconcentration of the financial sector. The diffusion of new values stemming from responsible investment could also, but perhaps only to a modest extent, produce necessary changes.

Unity and Variety of Financialization Processes

This detailed and comprehensive analysis of the links between the multiple forms of financialization and inequalities in the United States invites us to re-examine the question of the unitary nature of the financialization process across space, time, and within the different sectors of the economy.

The book suggests that the financialization described for the United States is also at work in other developed countries. Some global shocks, such as the end of the Bretton-Woods system (1971), which abruptly reactivated the foreign exchange market, do indeed affect all market economies. The central place of the United States in the world economy favors the global diffusion of trends such as the “shareholder revolution” that have emerged on its soil. Nevertheless, one should not underestimate the specificity of the U.S. banking system and the way it grants credit as a result of the strict regulations imposed by the Glass-Steagall Act (1933): banking fragmentation, strict separation of commercial and investment banks and the outsourcing of credit scoring. On the contrary, in many European countries, the financial sector was already

structured before the 1970s by large (quasi-)universal banks. The fact that finance contributed equally in Europe to the increase in inequalities in the years 1990-2000 therefore invites us to nuance the impact of the dismantling of the Glass-Steagall Act. On the other hand, this comparison invites us to place greater emphasis on the radical transformation of securities markets in the 1970s and 1980s, which led to an unprecedented extension of the field of arbitrage and speculation.[2] Its mainstay was the removal of corporatist regulations from former stockbrokers, the digitalization of transactions and the deregulation of derivatives trading.

A precise comparison of the timing and the extent of the different dimensions of U.S. financialization finally invites us to reduce an emphasis on the unity of the phenomenon, or even to replace this notion with other intermediate concepts. Thus, the first works on financialization, often of Marxist inspiration, insisted on the financialization of the income of non-financial firms as revealing a financial phase of capitalism in which firms would invest in the stock market rather than in real activity. Financial income grew significantly in the 1970s and 1980s. But it decreased just as much in the 1990s and 2000s (p. 14). This dimension therefore does not seem to be so crucial for thinking about contemporary financialization and its link with the growth in inequality.

It is also commonplace to suggest that the maximization of shareholder value is an important component of financialization. If this trend is manifested by a constant increase in dividends paid to shareholders since the early 1970s (Figure 1.2) and by an increase in executive-level compensation, its intrinsically financial character could be discussed. Even if it did not take as radical a form as the one theorized by Jensen and Meckling,[3] profit maximization has always been at the heart of capitalism and can be accentuated independently of developments in the financial sector. On the contrary, the spectacular development of some asset management firms such as BlackRock suggests possible tensions between the development of the financial sector and the shareholder value. Indeed, households, scalded by the stock market crisis of 2001, have largely deserted direct share ownership in favor of mutual fund or pension fund shares. The shareholder is less and less a real person. It is an abstract entity that

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[2]Arbitrage in finance consists in taking advantage of price differences for the same product on different financial markets or between two products of the same family on the same financial market.
[3]In a famous 1976 article, Jensen and Meckling propose new theoretical foundations for the firm on the basis of agency theory. The principal (the shareholders) establishes an optimal contract that induces the agent (the manager of the firm) to maximize the income of the shareholders. Cf. Jensen, Michael C., and William H. Meckling. "Theory of the firm: Managerial behavior, agency costs and ownership structure." *Journal of financial economics* 3.4 (1976): 305-360.

represents the employees in the financial industry. Moreover, since these asset management firms own a large share of the economy (the three largest owning 22% of the shares of the S&P 500 in 2018), they could in the future abandon the logic of maximizing shareholder value firm by firm and, on the contrary, act as "universal owners". This innovative idea was originally formulated by Hawley and Williams[4]. According to these scholars, pension funds could be a key piece of democratic capitalism. Pension funds represent current or future retirees. By owning all companies, they can promote the long-term growth of the economy as a whole, taking into account the negative externalities and positive complementarities of various activities. Recent work shows that these asset management firms form a capitalist oligarchy that is undemocratic and, for the time being, hardly concerned with the long term. Once assured of their power, these firms could nevertheless move away from the principles of maximizing single firm value creation.

Thus, even if financialization has been a convenient and fruitful concept for thinking about the transformations of contemporary capitalism and the development of inequalities, after 15 years of work, it might be more useful to develop and articulate more specific concepts such as the prioritization of shareholder value in non-financial firms, the generalization of household indebtedness, and the growing influence of financial markets as a mode of financial intermediation. Indeed, these three major transformations each have their own rhythms and a specific relationship to the development of inequalities.

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[4]Cf. Hawley, James P., et Andrew T. Williams. *The rise of fiduciary capitalism: How institutional investors can make corporate America more democratic*. University of Pennsylvania Press, 2000.