THE RISE OF FINANCE: WHAT IS IT, WHAT IS DRIVING IT, WHAT MIGHT STOP IT?

A Comment on "Finance and Labor: Perspectives on Risk, Inequality and Democracy" by Sanford Jacoby

Simon Deakin†

In "Finance and Labor"[1] Sanford Jacoby has dissected the relationship between labor and finance, laying bare the role that contemporary financial development has played in increasing inequality in developed nations and in contributing to the erosion of the welfare state. Rejecting efficiency-based explanations for these broad trends, Jacoby argues that their immediate cause lies in the political system and in the capture of the regulatory agenda by elite groups who are principal beneficiaries of financialization.[2] At a deeper level he points to long-run structural processes of change within market economies. We are witnessing, he suggests, the playing out of Polanyi's "double movement,"[3] but in reverse: as regulations and institutions designed to offset the effects of the market have gone into decline, they have been displaced by efforts to reinstitute the "self-regulating" market that many (both opponents and critics) associate with the nineteenth century or at least with pre-New Deal or pre-welfare state societies. Jacoby hints that we might be coming to the end of the long wave that began in the late 1970s.[4] It is an implication of Polanyi's theory that the "double movement" of regulation and the economy is cyclical, so we might expect a reversal at some point. What we do not know is when that point might be reached, although the financial crisis of October 2008 seems a likely candidate, matching Jacoby's prediction.

The recent rise of finance takes many forms, from the hostile takeover bids of the 1980s to the private equity deals and hedge fund

† Professor of Law, University of Cambridge.

1. Sanford M. Jacoby, 'Finance and Labor: Perspectives on Risk, Finance and Democracy' 30 *Comparative Labor Law and Policy Journal*, 17 (2008).

2. *Id.*

3. KARL POLANYI, THE GREAT TRANSFORMATION 132 (1944).

4. Jacoby, *supra* note. 1, at 49–50.

activism of more recent years, and it can be measured in various ways, such as the rise in stock market values relative to national wealth or the increase in the size and significance of the listed company sector within national economies.[5] At an organizational level, the rise of finance is reflected in the use of shareholder-value metrics to measure corporate performance, in the pre-eminence of CEOs with legal and financial skills and the corresponding marginalization of managers with operational and engineering skills, and in the introduction of "corporate governance"-style changes to board structure and executive remuneration.[6] The rise of finance can also be seen in the shifting boundary between the public and private sectors, which is evident not just in the selling-off of state-owned assets but in the growing use of private finance to direct investment into public infrastructure and to structure the provision of those services that remain in the public sector (such as education and, in some countries, health).[7]

In this extended sense, "finance" is not about what it used to be about, namely the techniques used to supply capital inputs to firms. The traditional practice of "corporate finance" has only a tenuous connection to the contemporary phenomenon of financial control of organizational and political life. Retained earnings are, in practice, by far the largest source of funds for corporate investment today as they always have been, but net retentions have been negative in the United States and Britain in most years since the early 1980s, just the point at which the shift toward shareholder value began to take hold.[8] Equity finance has not simply become less important as an input to corporate investment since that time. At least in the "Anglo-Saxon" systems its contribution, in net terms, has been negative,[9] the effect of high dividends and of the "retirement" of capital through mergers and

5. *Id.* at 20–25.
6. *Id.* at 26–27.
7. For a recent assessment of the implications of the Private Finance Initiative ('PFI') for the British National Health Service, which include rising costs of servicing debt, leading to growing deficits and cuts in services, see Mark Hellowell & Allyson M. Pollock, *Private Finance, Public Deficits: A Report on the Cost of PFI and its Impact on Health Services in England* (Centre for International Public Health Policy, University of Edinburgh, 2007), available at http://www.health.ed.ac.uk/CIPHP//documents/CIPHP_2007_PrivateFinancePublicDeficits_Hellowell_000.pdf (last accessed Aug. 31, 2008).
8. *See* Till van Treck, *A Synthetic, Stock-Flow Consistent Model of Financialisation*, (IMK Working Paper No. 06-2007, Hans Böckler Stiftung, 2007), *available at* http://www.boeckler.de/pdf/p_imk_wp_06_2007.pdf (last accessed Aug. 31, 2008).
9. There are, of course, inflows of equity capital to start ups at the point they make an IPO (or flotation), and already-quoted companies make rights issues from time to time, although for most companies these are rare events. In net terms, across the listed company sector as a whole, these inflows have been outweighed by share buy-backs and dividend payments, at least for Britain and the United States in the period referred to in the text.

takeovers, as well as, above all, "share buy-backs" or the practice (once legally restricted, but no longer) of companies returning capital directly to their shareholders through stock re-purchases. Thus the rise of finance has coincided with a decline in its traditional function, at least in the corporate sector.

"Corporate finance" as a theory concerning the relationship between markets and organizations is closer to the societal phenomenon that "finance" has become. The core of finance theory—the efficient capital market hypothesis—is the claim that the capital market, left alone, can accurately price the social value of alternative organizational arrangements. This is an idea that can be, and has been, applied not just to the evaluation of managerial strategies in the context of the private sector, but to the way the public sector is organized (via "private finance initiatives"[10]) and, ultimately, to the political process itself (which to this end is analogized to a market, although, as public choice theory argues, a rather peculiar and less than perfectly efficient one, by comparison to the capital market). "Finance," as a mode of social organization, *is* the self-equilibrating market, writ large.

Polanyi emphasized, and Jacoby reiterates, the huge regulatory effort required to bring the "self-equilibrating" market into being, or at least into something approximating its theoretical form. This is not in simply a case of "deregulation." The pre-eminence of finance requires the systematic removal of "distortions" of competition. Because the idea of the self-equilibrating market is unrealizable, this is a never ending task, but its unattainability does nothing to deter those who argue for this approach. At a domestic level, it implies the constant undermining of collective bargaining, social insurance, and other welfare state institutions. At a transnational level, it takes the form of attacks on national regulatory systems on the grounds that they constitute restrictions on the transnational flow of resources.[11] These are processes that require activism on the part of lobby groups, legislatures, and courts. New restrictions on civil society organizations

10. Hellowell & Pollock, *supra* note. 7.

11. A recent manifestation of this is the use of free movement jurisprudence in European Union law to strike down national legislation which is said to "restrict" or "distort" the cross-border supply of goods and services. Case C-438/05, *International Transport Workers' Federation v Viking Line ABP*, judgment of Dec. 11, 2007, and Case C-341/05, *Laval un Partneri Ltd v Svenska Byggnadsarbetareförbundet*, judgment of Dec. 18, 2007. *See* Alain Supiot, 'L'Europe gagnée par "l'économie communiste de marché"' *Revue du MAUSS permanente*, *available at* http://journaldumauss.net/spip.php?article283 (accessed Aug. 30, 2008).

are being imposed in the name of preserving market "freedoms."[12] The institutions being undermined in this way are almost invariably those that have an egalitarian, risk-sharing, or income-smoothing function. The principle of "market transparency" is never invoked to favor leveling-up across national regimes, in this approach, only to level down. The particular relationship between finance and inequality is an illustration of this wider phenomenon. For the financial reorganization of society to take hold, inequality is a necessity, and not simply a by-product of finance's rise. The financialization of the assets on which households depend for economic security requires the cutting back of mechanisms for risk-sharing such as social housing programs, state-administered social insurance, and collective wage determination, as evidenced by the enormous lobbying efforts devoted to this end by "pro-market" think tanks and foundations.

Growing inequality and the rise of finance would therefore seem to be mutually reinforcing trends. The political process plays a role here. According to Jacoby, inegalitarianism is self-perpetuating, because of the way in which political coalitions are formed. It has proved difficult for progressive parties to piece back together the coalition of organized labor, public service professionals, and smaller business owners, once the goal of preserving the welfare state is seen as a lost cause. Conversely, well-endowed and well-organized lobby groups can have an influence beyond the relatively small constituencies they represent.

The question left hanging at the end of "Finance and Labor" is whether the current paradigm is stable. There are signs that it may not be, but this is nothing new. The rise in stock market values in the 1990s, far outstripping GDP in both Britain and America, was not in principle sustainable; the "virtual wealth" created by share price increases on that scale could not be tapped without triggering a negative market reaction that would then remove the source of the gains (except for those fortunate or far-sighted enough to exit the market at the right moment).[13] To some extent this accounts for the period of relatively restrained stock market growth (by 1990s standards) that has occurred since the bursting of the dotcom bubble in 2001. The subsequent credit expansion, however, illustrates the

12. Thus one of the implications of the *Viking* and *Laval* judgments (see previous note) is a new set of restrictions on the right of trade unions to organize strike action and to defend the terms of collective agreements.

13. Amit Bhaduri, Kazimiertz Laski & Martin Riese, *A Model of Interaction between the Virtual and the Real Economy*, 57 METROECONOMICA 412–27 (2006).

capacity of the financial paradigm for self-renewal: asset price inflation, this time in the housing market, was used to lever a growth in credit, helping to call into being a credit market boom to match that of the stock market a decade earlier. That this phase has now ended, amid new revelations of financial fraud, has given policy makers pause for thought. Central bankers and financial market regulators are said to believe that to restart the cycle would be to risk a similarly negative market "reaction," possibly an even more disruptive one, in a few years' time.[14] However, they might privately be asking whether the high levels of growth enjoyed by the British and American economies since the mid-1990s can be maintained without another asset-price bubble of some kind.

The turning of the economic cycle provides, as it always does, an opportunity for critics of current policy to assert alternatives, and it offers the possibility of constructing a political coalition in favor of re-regulation. The reappearance of issues such as the living wage and tax fairness on the political agenda in the past few years is indicative of a growing concern with the implications of the widening income gap. Another key issue, and one Jacoby discusses at some length, is that of pension fund activism. The pensions question puts into very sharp relief the paradoxes and contradictions of financialization. Pension funds purport to be acting on behalf of their members, many of whom are current employees. Although such members will most likely have a strong interest in maintaining job and income security, pension fund trustees (or their fund manager agents) are prepared to countenance hostile takeovers that lead to downsizing, and pension funds are significant investors in private equity portfolio companies whose strategies may depend on (and certainly lead to) job cuts and de-unionization.[15] Of course, the companies targeted for downsizing are not those employing the members of the pension scheme in question. But there will most likely be another pension scheme, elsewhere, putting pressure on their employer to ensure that high returns are met, if necessary by shifting some of the risk of restructuring on to the workforce.

14. Some of them, at least, appear to take this view. According to *The Times*, 30 April 2008, "the days of City 'hubris' must come to an end, the Bank of England cautioned yesterday in an extraordinary attack by Mervyn King, the Governor, on excessive pay packages and heavy risk-taking," Gary Duncan, *Mervyn King: Banks paying price for their greed*, THE TIMES, Apr. 30, 2008 (referring to a statement made by the Governor of the Bank of England to a House of Commons Select Committee), *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3842764.ece..

15. Jacoby, *supra* note 1, at 41–42.

The process truly comes full circle when the corporate sponsors of defined-benefit schemes take steps to close them to new members or, as is increasingly happening in Britain, "abandon" them entirely,[16] selling up to insurance companies or to pension buy-out specialists who see in the funds an opportunity for arbitrage.[17] Companies are doing this in part because the pension fund deficits revealed (or on another view crystallized) by tougher accounting standards[18] have a negative impact on the stock market value of the firms concerned. In some cases, it is pension funds themselves who are making the call for the companies they are investing in to switch to defined contribution schemes, in which the risk falls exclusively on the employee-members and the employer's contributions are almost invariably below the levels seen in defined-benefit schemes.[19]

Under these unpromising circumstances it is perhaps not very surprising that little progress has been made in harnessing the apparent power and influence of pension funds to the cause of realigning managerial strategies. The "fiduciary" logic pension fund trustees must observe gives them limited room to maneuver. They

16. Pension fund "abandonment," as it has come to be known in Britain, has been defined as occurring where "the sponsoring employer severs its link with the scheme without providing the scheme with sufficient funds or assets to compensate for losing the ongoing support of its employer." *Abandonment of Defined Benefit Pension Schemes*, THE PENSIONS REGULATOR, May 2007, at 3, *available at* http://www.thepensionsregulator.gov.uk/pdf/abandonmentGuidance.pdf (accessed Aug. 31, 2008). It can take a number of forms including the replacement of a defined benefit scheme with a defined contribution scheme for some or all of the active members, or a pension fund buy-out.

17. Where a buy-out occurs, the responsibility for administering the scheme is vested in the insurance company which purchases it. There is no longer any need for the trustees, and the rules and principles of financial regulation which govern investments made by insurance companies take the place of fiduciary law as it applies to the trustees. For a buy-out to feasible, the scheme must normally be in surplus at that point, but there is evidence that companies are considering buy-outs in order to forestall problems arising from future deficits, and to bolster market confidence in their stock; in response, the number of buy-out firms is growing, and includes several new players specializing in this branch of financial management, a development which may be expected over time to drive down costs and make buy-outs more attractive for scheme sponsors. Lane, Clark and Peacock LLP, *Removing Pension Scheme Risk in the Buyout Market* (London, 2007), *available at* http://www.lcp.uk.com/services/documents/buyout_removing_risk.pdf.

18. Financial Reporting Standard 17 (FRS17) has considerably tightened up the reporting of deficits, which were previously rolled over in the expectation that funds would return to surplus at a later point in the cycle. FRS17 was first published in 2000 and became mandatory for all UK companies in January 2005.

19. Teresa Ghilarducci provides an example of a similar case in the U.S. context in WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 69 (2008). In the United Kingdom, there have been calls from pension fund consultants for British Telecom to close its defined-benefit pension scheme to new members, on the grounds that pension fund deficits are negatively affecting its share price performance. Phillip Inman, *Pensions can "wipe out BR profits,"* THE GUARDIAN, Feb. 7, 2008, *available at* http://www.guardian.co.uk/business/2008/feb/07/btgroupbusiness.pensions. BT's defined-benefit pension fund is managed by Hermes, one of the most influential advocates of stricter corporate governance standards.

may legally adopt a "mixed" investment strategy that allows social and environmental considerations to be taken into account where they do not conflict with the long-term financial security of the fund, but few funds are making this choice and trustees argue that the focus of their activity must lie elsewhere, in maintaining the solvency of funds that are increasingly under threat. Unions can try to influence investment practice through their membership of the boards of, mostly, public-sector pension schemes, but there are both legal and political barriers to this strategy in the United States. In the United Kingdom union influence is more limited than it is in America: member-nominated trustees are a relatively recent innovation in defined-benefit schemes and unions have no direct say in their appointment. Unions are offering training to member-nominated trustees and through the pension schemes they operate for their own staff they are seeking to encourage the relatively small but growing number of City-based fund managers running socially responsible investment practices. As yet, however, limited headway is being made. Union pressure does not seem to have led to significant pension fund divestments from private equity, for example.

The pension fund issue is a striking example of a situation in which better or more carefully targeted regulation could help bring about a reversal of the negative effects of financialization. Steps could be taken to stabilize defined-benefit pension schemes, by allowing them to take their advantage of their intended longevity and long-term investment horizon to ride out fluctuations in returns over the economic cycle. However, recent attempts at re-regulation have been running in the opposite direction, forcing funds to focus on the short term. In both America and Britain, the response to a number of high-profile pension fund failures in the late 1990s and early 2000s was to strengthen state-backed guarantee schemes that would provide (partial) compensation for those affected by scheme failures. However, in order to reduce the risk of scheme failures falling entirely on the state, regulation of employer-based schemes was tightened up, with stricter rules on deficits and new powers vested in regulatory bodies to demand increased contributions from employers. The upshot, in both countries, has been to make defined-benefit schemes less attractive than ever to sponsors.[20] While it is unclear how far this

20. For the United States, see GHILARDUCCI, *supra* note 19, at ch. 3, describing the impact of the Pension Protection Act 2006. In Britain the Pensions Act 2004 gave the newly established Pensions Regulator the power to require shortfalls in defined-benefit schemes (as defined by reference to the actuarial interpretation of deficits set out in FRS17) to be made good immediately, increasing the pressure on employer-sponsors to maintain fund solvency in both

stricter regulatory environment has been responsible for declines in the coverage of defined-benefit schemes, at a time when a number of other factors are in play, it has probably not helped. In the Anglo-American context, we are some way from seeing a coherent regulatory response to the issue of pension fund security, let alone measures that could offer meaningful support to unions and other civil society actors in pressing the case for a more socially informed approach to investment strategy.

As Jacoby suggests, things may be different in so-called "coordinated market economies."[21] Systems such as France, Germany, and Japan have legal regimes that, in many aspects, are just as protective of shareholder rights as those in Britain and America, if not more so. Where they differ is in continuing to place limits on the market for corporate control and in allowing companies some discretion in responding to pressures for short-term returns from activist shareholders. France and Germany adapted their laws to the European Union's Directive on Takeover Bids, which essentially follows the British model of the City Code but allows Member States some flexibility in its implementation, by preserving a role for pre-bid defenses, which can be authorized by the board (the supervisory board in the German case) without the need for prior shareholder authorization.[22] In Japan, following the Livedoor bid of 2005,[23] ministerial guidance,[24] together with several court rulings,[25] provided advice for boards on how to respond to hostile takeovers. Although the principle of shareholder sovereignty is stressed at a formal, rhetorical level, the guidelines indicate that boards are entitled to put poison-pill type defenses in place, subject only to the possibility of subsequent review by shareholders. The courts have said that boards are entitled to resist hostile bids where, among other things, the

---

the short and long run, and adding to pressure for abandonment: Simon Deakin & John Buchanan, Pension Fund Governance: The Evolution of the Trust Model (mimeo, Centre for Business Research, University of Cambridge, 2008).

21. Jacoby, *supra* note 1, at 34–35, 62–63.

22. *See* Paul Davies & Klaus Hopt, *Control Transactions*, *in* THE ANATOMY OF CORPORATE LAW (Reinier Kraakman et al. eds, 2d ed. 2009).

23. CURTIS MILHAUPT & KATHARINA PISTOR, LAW AND CAPITALISM ch. 5 (2008).

24. METI & Ministry of Justice, *Guidelines Regarding Takeover Defence for the Purposes of Protection and Enhancement of Corporate Value and Shareholders' Common Interests* (Tokyo, 2005), *available at* http://www.meti.go.jp/policy/economy/keiei_innovation/keizaihousei/pdf/shi shin_youyaku.pdf.

25. Most notably in the Livedoor case itself and, more recently, in the Bull-Dog Sauce case, which arose form a hedge-fund intervention.. *See* Hugh Whittaker & Masaru Hayakawa, Contesting "Corporate Value" through Takeover Bids in Japan, 15 CORP. GOV.: AN INT'L REV. 16–26 (2007), *available at* http://www3.interscience.wiley.com/cgi-bin/fulltext/117967224/PDFSTART.

bidder is a "greenmailer" out for short-term gains or has no effective long term plan for ensuring the company's sustainability. Running through the Japanese debate are references to a concept of "corporate value," defined as "those attributes of the company or the level of such attributes that contribute to shareholder value, such as the company's assets, its profitability, its stability, its efficiency, and its growth,"[26] which offers a distinctively organizational perspective on corporate governance, at odds with the British or American conception of the firm as a bundle of financial assets at the shareholders' disposal. More recently, there have been several high-profile interventions by activist hedge funds, with mixed success. It is perhaps too soon to evaluate these developments, but it would seem that hostile takeover bids and hedge fund interventions do not (yet?) enjoy the legitimacy they have in the United States and Britain. Hostile takeovers were actively suppressed in the post-war years in Japan as part of the process of industrial regeneration,[27] and it is this model, rather than the Anglo-American one, which may in the future appeal to developing nations.[28]

The "varieties of capitalism" approach has been highly effective in explaining the origins of diversity in corporate governance systems, and thereby highlighting the limits to the replicability of the Anglo-American model. But where does this leave the liberal market systems? Are they destined to remain on their current path? Jacoby's historical perspective suggests that financialization can be reversed, even in these systems, and that we might be approaching the point where such a turn looks feasible once again. But even after the crisis of October 2008 it will surely require no small intellectual and political effort to bring this about.

26. METI & Ministry of Justice, *supra* note 24.

27. *See* Masahiro Okuno-Fujiwara, *Japan's present-day economic system: its structure and potential for reform*, *in* THE JAPANESE ECONOMIC SYSTEM AND ITS HISTORICAL ORIGINS 266 (Tetsuji Okazaki & Masahiro Okuno-Fujiwara eds., 1999).

28. Simon Deakin & Ajit Singh, *The Stock Market, the Market for Corporate Control and the Theory of the Firm: Legal and Economic Perspectives and Implications for Public Policy*, *in* THE ECONOMICS OF CORPORATE GOVERNANCE AND MERGERS: ESSAYS IN HONOUR OF DENNIS MUELLER (Klaus Gugler & Burcin Yurtoglu eds., forthcoming 2009).