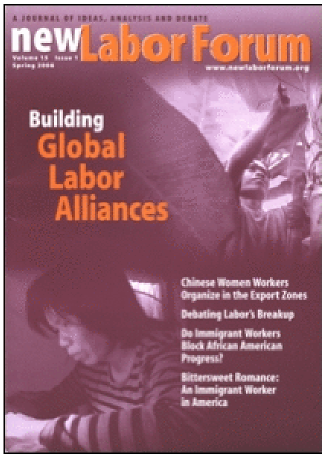


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# WALL STREET VS. THE LABOR MOVEMENT

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*Brian Fairrington, Cagle Cartoons*

By Özgür Orhangazi

# WALL STREET VS. THE LABOR MOVEMENT

In recent years, private equity funds—firms that pool funds from investors to buy companies, restructure them, and re-sell them—have acquired firms in various sectors and dominated the news headlines in the business press. In 2006, there were more than a thousand private equity buyouts worldwide, with an estimated value ranging from five hundred to seven hundred billion dollars.

*Business Week* reports that the private equity industry's size is over a trillion dollars and that there are about three hundred billion dollars worth of deals in the pipeline.[1] At the same time, there are other types of financial institutions such as hedge funds, which are investment funds that invest in almost every type of financial assets with the supposed aim of hedging against downturns in the markets and reducing volatility and risk. However, these investment funds themselves also create increased risks due to their large speculative investments. Then there are real estate investment trusts (REITs), companies that engage in speculative investments in real estate properties while benefiting from certain tax advantages. These have also displayed immense growth and attracted much public attention. The rise of these new institutions has had a profound impact on economic performance in general and labor relations in particular. This article contextualizes this recent boom in private equity funds and such within the framework of financialization, and outlines their direct and potential impacts on labor.

In a process known as financialization, both the size and importance of financial markets, transactions, and institutions have grown

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continuously since the 1980s. Incomes derived from financial sources as opposed to nonfinancial sources have grown, while the total debt in the economy has skyrocketed. For example, the value of total global financial assets (equities, government and corporate debt securities and bank deposits) was 12 trillion dollars in 1980, rose to 64 trillion in 1995, and soared to 140 trillion dollars by the end of 2005. Total value of global financial assets was 338 percent of the global gross domestic product in 2005, up from 109 percent in 1980. And in the U.S. economy, the stock of financial assets reached 303 percent of the GDP in 1995 and 405 percent in 2005.[2] In the same period, financial sector profitability, employment, and compensation levels increased. Profits from financial market activities as a share of gross national income, the so-called "rentier share" in the economy, more than doubled from 1960 to 1999, reaching almost 20 percent in the United States.[3]

The increasing financialization of the U.S. economy has had a profound impact on nonfinancial corporations (NFCs). It has changed the way corporations are run and for what purpose. Prior to the era of financialization, industrial corporations mostly retained and reinvested their earnings with a strategic view toward long-run profitability. Since then, the distribution of earnings to shareholders has supplanted all other business priorities. Corporate strategy now focuses on downsizing the labor force. The switch from the "retain and reinvest" strategy to the "downsize and distribute" strategy obliges management to satisfy the short-term profit maximization goals of shareholders.[4] This fundamental revision of corporate priorities is driven by the power of institutional investors (mutual funds, insurance companies, public and private pension funds). The share of corporate stocks held by institutional investors was less than 10 percent in 1950, 28 percent in 1970, and exceeded 50 percent by the 2000s. The hostile takeover movement of the 1980s initiated a vigorous market for the control of corporations that especially targeted companies showing weak financial performance. Institutional investors with deep pockets made it possible to launch hostile takeovers even against the largest corporations. During the 1980s, nearly half of the major corporations in the United States received a takeover offer.[5] Most importantly, all firms felt the threat, whether targeted or not, and consequently were restructured in order to make themselves less attractive targets for takeover bids.

Even though hostile takeover activity declined after 1987, the pressure on corporations remained acute through the following decade.[6] Institutional investors began getting actively involved in corporate governance. "Maximization of rate of returns on equities" became the main goal of top management, which focused almost single-mindedly on distributing corporate incomes in ways that would support or increase the price of corporate equities. Managers had to increase "shareholder value" both to avoid a potential takeover of the firm and to protect their jobs. Today, those corporations that do not pay "adequate" dividends or have low-priced shares are vulnerable to attack. Furthermore, the interests of managers and shareholders were "aligned" through the introduction of large stock options. Stock options encourage management to take actions that may boost the price of the company's stock but may not otherwise be in the firm's best long-term interest. In most cases, managerial compensation is tied to dividend payouts which encourage managers to increase dividend payments.

This short-term focus of shareholders is clearly seen in the stock market turnover rate, which measures the average duration a shareholder holds the company shares. The average shareholder now holds shares for less than a year, down from an average of five years in the pre-1980 era.[7] To keep stock prices high, NFCs also allocate an ever-rising portion of their earnings to buy back their own stocks. With the exception of the early 1990s, the stock market has become not so much a place to raise capital but rather a means to re-circulate earnings into short-term financial markets, as NFCs became net buyers of NFC stock. Total financial payments of the NFCs, including interest payments, dividend payments, and stock buybacks now take away almost all of the NFC internal funds. At the same time, the short-term outlook that informs corporate strategy has also led NFCs to increase their investments in financial assets as opposed to productive capital accumulation. More than half of the assets of NFCs are now in financial forms, while financial incomes (interest income, dividend income, and capital gains) make up more than 30 percent of NFC internal funds.[8]

As the focus of economic activity shifted in this way, financial players such as private equity funds, hedge funds, and REITs became short-term owners of all sorts of nonfinancial corporations, acquiring manufacturing and services firms. These financial players acquire firms in order to restructure and dispose of them for a profit as portfolio assets without regard to their long-term productivity and profitability. The short-term profit maximization focus of private equity funds is apparent in the fact that they sell off their acquisitions on average in two to three years.

The proponents of these transformations in the relationship between the financial markets and the NFCs argue that the new corporate strategy increases the overall efficiency of the NFCs by allocating the funds to their best available uses. They claim it eliminates inefficient management, or forces it to use company resources in more efficient ways. They maintain that a corporation is a "nexus of contracts" and its purpose is to allocate residual cash flow among managers, creditors, and shareholders. Having a takeover market that functions as a market for corporate control provides the necessary discipline and incentive for corporate managers to create higher profits. However, increased dominance of financial markets and institutions over NFCs hampers the long-term investment needs of these companies. It also increases inequalities in the economy by directing a higher share of resources to capital owners. For example, most of the NFC borrowing now is short-term. NFCs must allocate their earnings to the financial markets and then compete for the use of these funds with all other

*Private equity funds, hedge funds, and real estate investment trusts became short-term owners of all sorts of nonfinancial corporations, acquiring manufacturing and services firms.*

domestic and international financial actors. Furthermore, financialization creates another incentive for NFCs to increase their investments in financial assets which give quicker returns that can then be used to satisfy the financial markets earnings demands. The returns to investors average around 20-25 percent, while reaching as high as 40 percent for the biggest private equity funds. For example, when Texas Pacific acquired Burger King in 2002, it received 448 million dollars in dividends from the company, an amount that was almost equal to the acquisition price. In 2006, when 26 percent of the company was resold to the public, the private equity group's remaining holdings were valued around 1.8 billion dollars.[9] Moreover, private equity firms charge the companies they acquire a fee for "advice" on the deal. These fees can amount to 5 percent of the funds under management. For example, when Blackstone acquired Celanese Corporation in 2004, it charged the company 45 million dollars for "advising fees."

Critical studies of financialization in general and takeover activity in particular point out that financial gains are created at the expense of economic losses imposed on other groups connected with the firm, including employees, customers, suppliers, local communities, and taxpayers. Cost-cutting pressures in most cases result in a reduction in employment, wages, or benefits, and sometimes all of them. In many industries, labor is the major component of costs and since it is usually not possible to cut down costs by pressuring the suppliers of other inputs, labor becomes the only major cost item that management can control; massive layoffs have become routine in the era of financialization. Financialization encourages outsourcing, production transfers, and plant closures The divergence between capital and labor incomes is, among other factors, a direct consequence of the changes in the corporate governance system, as both institutional investors and, more recently, the private equity funds, direct an increasing share of corporate resources towards financial investors.

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Of course, getting more out of fewer workers has always been a goal of management. However, in the financialization era, NFCs increasingly act more like financial market players, and see their own firms as a bundle of portfolio investments, treating parts of their own corporations as liquid assets that can be floated in the financial markets if they underperform. At the same time, corporate leaders look at other firms as liquid assets to be added to their firm's portfolio, if acquiring them can increase expected returns. Studies show that while the stock market reacts negatively to layoffs attributed to low demand, it responds positively to restructuring-related layoffs by an average of 1.9 percent.[10] Hence, a big contradiction of financialization is that the financial markets thrive on shifting resources away from productive investments.[11]

The boom in private equity funds and the accompanying takeovers reinforce these dynamics. The advantage of takeovers from the perspective of capital is that the acquirers are generally in a better position to breach not only explicit contracts but implicit contracts with both labor and suppliers of other inputs, which the original management would most likely have maintained. The recent boom in private equity funds has produced results similar to the hostile takeover waves of the 1980s, and in some cases is even driven by the same financial actors, most famously Kohlberg, Kravis, Roberts & Co. (KKR). In addition to the need to increase the value of the companies bought to satisfy investors, private equity funds also have to pay off the debt used to complete the deal. Hence, they often sell off the assets of the acquired company in addition to squeezing the workers.

When the firms are restructured to make them appealing to the financial markets, jobs, health and retirement benefits, and other commitments to employees are often seen as costs that need to be eliminated as much as possible in order to enhance the resale value of the company and make it easier to discharge the debt obligations taken on to purchase it in the first place. For example, after KKR acquired Nabisco, now part of Kraft Foods, unionized jobs in the company were eliminated together with the benefits associated with them. Furthermore, much of the productive capacity of the company was also sold off. *Business Week* commented that "[p]rivate equity firms are using slick new tricks to gorge on corporate assets, helping themselves to fat fees while leaving the companies they sell dazed and depleted."[12] The private equity boom is not limited to the United States. For example, in the United Kingdom, two months after the purchase of the country's second largest biscuit manufacturer, Burton's Foods, by the private equity firm Duke Street Capital, it was announced that the company would cut around 660 jobs. And when Lion Capital acquired the multinational Kettle Foods, it called in professional union busters to prevent a union drive in the company's Norwich facilities.[13] Back in the United States, a recent report by the *New York Times* compared 1,200 private equity-owned nursing homes with 14,000 others over the last six years and found that the acquisition of the nursing homes was followed by cuts in expenses including cuts in staff and registered nurses, even reducing staff below minimum legal requirements.[14]

*Massive layoffs have become routine in the era of financialization.*

While this process is underway, workers are confronted with an owner who does not have a long-term interest in the company and so is not inclined to negotiate. The owners are shifting groups of investors that essentially attempt to maximize their returns in the global financial marketplace. This has significant implications for labor-capital relations. In most cases, labor may no longer be able to seek changes in conditions through negotiating the impact of restructuring or closures, productivity improvements, increases in productive capacity, the introduction of new product lines, and the long term outlook of the firm. The new owners have no real interest in these questions. In this environment, the possibility of a viable pact between labor and capital vanishes. Under the regime of financialization, owners, scarcely see themselves as employers. Nor are they defined as employers and usually do not have the legal obligations that are binding on employers. For example, one of the leading private equity funds, The Blackstone Group, officially has less than a thousand employees, while it owns companies with a total labor force of hundreds of thousands.

The impact on collective bargaining can be quite blunt. In the United Kingdom, the private equity fund Texas Pacific Group acquired Gate Gourmet, the catering division of Swiss Air. It then intervened in the negotiations between the company and the striking workers. Although the company management and the striking workers had reached a deal in December 2005, the Texas Pacific Group pressured the company management to scrap the deal, while refusing to directly participate in the negotiations. From the date of acquisition to the time this private equity group sold off the company, total employment fell from 25,000 to 20,000.

*Workers are confronted with an owner who does not have a long term interest in the company and so is not inclined to negotiate.*

Although the immediate effects of the takeovers seem to be damaging to labor in general, their consequences in the medium to long run are not clear either for labor or for capital. In some cases, while the labor costs are initially suppressed, subcontracting and hiring outsiders for some of the positions that were eliminated tend to create new costs. While this process is likely to increase the inequalities in the labor market by further decreasing job security for an increasing number of employees, these effects are not well-researched. Likewise, it is uncertain how increased financialization and corporate restructuring affects the productive capacity of the economy in the long run.

Private equity funds are highly unregulated firms with exemptions from disclosure requirements and without SEC (Securities and Exchange Commission) oversight, since they are not publicly traded companies. Many critics of financialization point out that the lack of regulation in general increases the systemic risk in the economy. This is especially so with the increased use of debt in financing private equity firms, which increases the possibility of overborrowing, and increases firm and lender bankruptcy rates. On average, private equity funds borrow 80 to 90 percent of the funds necessary for takeovers. The collateral for the borrowing is the assets of the acquired company. The company thus ends up taking the debt onto its books and must meet the necessary interest and principal payments. Although anecdotal evidence suggests that private equity increases leverage in the companies they acquire, systematic data is unavailable on this aspect since the private equity funds fall mostly outside the regulatory framework and, as in most cases they are not publicly traded companies, they do not have to disclose details of their financial dealings. Furthermore, the fee structures and the tax advantages in these private equity deals contribute to the concentration of wealth and political power and increasing income inequalities. For example, in most cases, private equity firms treat their income as "capital gains," which is taxed at a much lower rate, 15 percent, as opposed to the 35 percent income tax rate. It is estimated that in 2006 alone, the Blackstone Group thus saved around 310 million dollars in taxes on its investments of around 1.5 billion dollars.

The response of the U.S. labor movement to financialization and the takeover waves that accompanied it has been mixed. This might be attributed to the fact that many pension funds benefit from the financialization process. Critics note that during the private equity boom, many pension funds, especially public sector ones, have invested considerable amounts in these private equity firms and hedge funds to profit from the recent boom in financial markets. For example, the largest pension fund in the United States, the California Public Employees' Retirement System, is in the process of increasing its investment in hedge funds from 800 million to 3.8 billion dollars.[15] Of course, if these ventures fail to create the expected returns, a reduction in pension benefits would be a likely consequence. The increases in the returns of pension funds of some workers come at the expense of the restructuring of other firms and the worsening of the condition of other workers. This creates a serious contradiction for the labor movement. And it adds to the increasing inequalities in labor markets. How labor comes to terms with the wide-ranging impacts of the financialization process is bound to become a more pressing issue in the years ahead. ■

*The lack of regulation increases the systemic risk in the economy.*

## Notes

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