Financialization is Marketization!

A Study on the Respective Impact of Various Dimensions of Financialization on the Increase in Global Inequality

(Sociological Science – forthcoming)

Northwestern University Workshop on Global Inequality

12 May 2016

Olivier Godechot

Sciences Po, MaxPo and OSC-CNRS

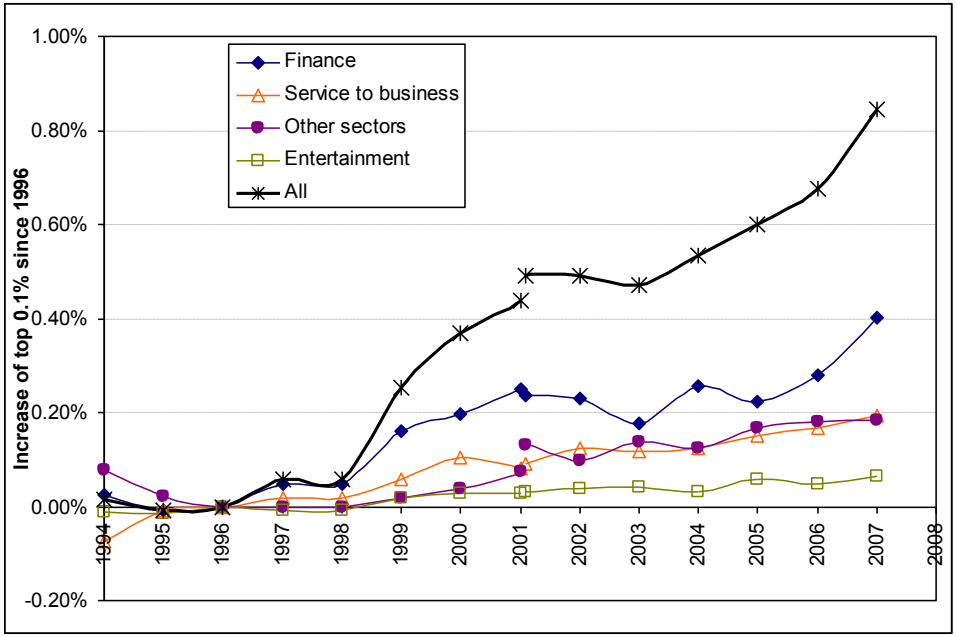
Olivier.Godechot@sciencespo.fr

Two major changes in world capitalism

- Increasing (wage, income, & wealth) inequality (Piketty et al.)
- Growth of finance
  - #OCCUPY (Wall Street, La défense, London Geneva)
    - Linking Finance & inequality
  - Are those two phenomena related and how?
- A link with multiple issues
  - A larger approach of the social impact of finance beyond booms and busts
  - A possible indicator on the rent extracting nature of finance
  - A case study on elite formation

What do we know yet?

- Sector decomposition of wage & income inequality
  - 1/6 to 1/3 of the rise income inequality in United-States (Philippon and Reshef 2012; Bakija, Cole, and Heim 2010)
  - ½ in France (Godechot 2012)
  - 2/3 in UK (Bell and Van Reenen 2013)



		Top 10%	Top 1%	Top 0.1%	Top 0.01%
France Panel	Share in 1996	26.45%	5.74%	1.20%	0.27%
	Share in 2007	27.74%	7.06%	2.01%	0.65%
	Increase in the share	1.29%	1.32%	0.81%	0.38%
	Contribution of finance to this increase	51%	47%	57%	69%
France Exhaustive files	Share in 1996	25.67%	5.43%	1.10%	0.23%
	Share in 2007	27. 70%	6.97%	1.95%	0.60%
	Increase in the share	2.03%	1.54%	0.85%	0.38%
	Contribution of finance to this increase	33%	39%	48%	57%
UK 1998-2008 (Bell and Van Reenen, 2010, Table 3 - ASHE)	Increase in the share	3.00%	1.80%	-	-
	Contribution of finance to this increase	73%	72%	-	-
US 1997-2005 (Bakija et alii, 2010, Table 5 & 6)	Increase in the share		2.54%	1.65%	
	Contribution of finance to this increase		32%	31%	

Towards a generalization of the finance/ inequality link ?

- Exploitation of inequality & finance databases : *Word Top Income Database, and Swiid, OECD & World bank*
  - Link between financialization and inequality with the Gini and top 1% (swiid) (14 countries, 20 years) (Kus 2013; Dünhaupt 2014).
- Analyze with more precision the impacts of financialization at several levels of the income distribution
- Discriminate between different varieties of financialization

What we want to show

- Financialization
  - A major factor of increase in income inequality
  - Increases income gaps especially at the top of the income distribution
  - Especially when this financialization is a marketization/ securitization
    - Marketization as the increase in social energy devoted to the trade of financial securities.
- Three parts
  - Which financialization should matter and why?
  - A sector approach of financialization
  - Varieties of financialization and their respective impact

The sector approach as first proxy of financialization

- (Simple) Share of the financial sector (with or without insurance)
  - × 1.7 in the US (from 5 to 8%) between 1980 and 2007 (Greenwood and Scharfstein 2012)
  - Sector decomposition of wages (Godechot 2012; Bell and Van Reenen 2013; Boustanifar, Grant, and Reshef 2014) of income and profits (Tomaskovic-Devey & Lin, 2011)
  - Rents in finance and the unequal share of the rents
- Internal limits
  - Traditional finance (retail banking / bankarization of the 1960s) not that much unequal
  - Market finance
- Financialization beyond finance sector :
  - Non-finance firms and households

Financial markets might produce specific inequality mechanisms

- Human capital important on the market but does not account well for pay discrepancies
- Superstar market mechanisms (Gabaix, Landier, 2008, Célérier, Vallée, 2015).
  - Requires a perfect knowledge of productivity
  - Innate talent not at odds with evidence of rents (Oyer, 2008)
- Hold-up mechanisms (Godechot, 2008, 2014)
  - "Acquired talent": financiers appropriate and carry financial activity (knowledge, know-how, customers, teams)
  - Can (threaten to) move those assets, they did not fund, elsewhere.

Financialization of non-finance firms: 1/ Shareholder orientation

- A new governance regime in firms giving priority to shareholders (Fligstein, 2002)
  - Dividend distribution and shares buy-backs (shifting from *retain and reinvest* to *downsize and distribute*) (Lazonick & O'Sullivan, 2000)
  - Debt as a resource and a discipline (Dobbin & Jung, 2015)
  - Stock-options and alignment of CEO interests and that of shareholders
  - Dediversification (Zuckerman, 1999)
  - CFO (Zorn, 2004)
    - An ideology serving institutional investors (managers) rather than shareholders (Dobbin & Jung, 2015)

Financialization of non-finance firms: 2/ bankarization

- Non corporate firms behave more and more as banks
  - Automobile industry selling more car credits than cars
- Krippner (2005)
  - Rising share of cash flow coming from portfolio income
  - 10% to 40% between 1970 to 2000
- Lin, Tomaskovic & Devey (2013)
  - Rising share of financial income over realized profits
  - Strong change in manufacturing firm
- Consolidation issue

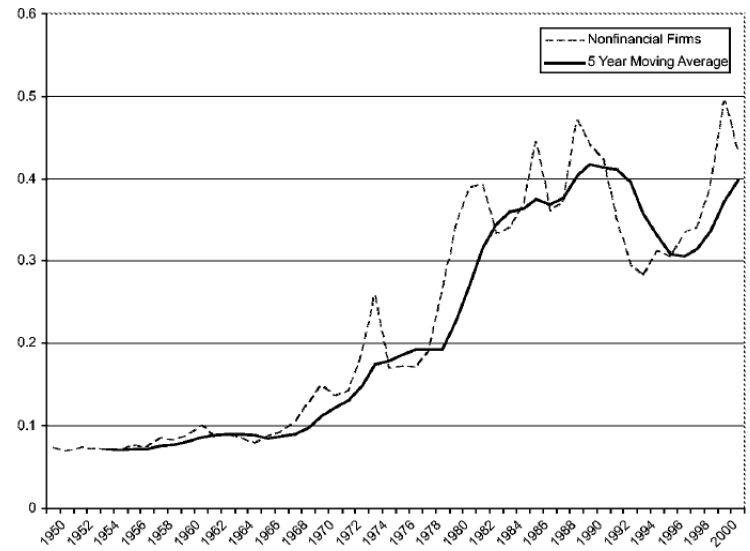


Figure 4 Ratio of portfolio income to cash flow for US non-financial corporations, 1950–2001.

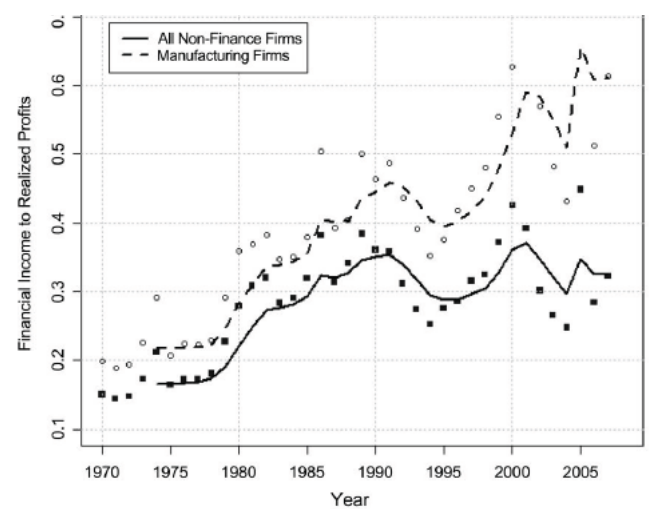


FIG. 1.—Financial income over realized profits, 1970–2007. Data are from the Internal Revenue Service Corporation Complete Report, 1970–2007. Financial income is calculated as the sum of interest, dividends, and net capital gains.

Financialization of non-finance firms

- Shareholder orientation inequality mechanisms
  - More dividends for shareholders
  - Low wages crushed through downsizing pressure
  - Higher wages for executives
  - Financial sector intermediation
- Bankarization inequality mechanisms
  - Same as previous
  - Shift from production towards banking like activities

Financialization of households

- Savings through financial securities
  - Rise of popular capitalism (Harrington, 2008; Fligstein & Goldstein, 2015)
    - But decline of securities (outside pension funds) in the bottom 90% as a form of saving (Saez & Zucman 2014).
  - Shift towards pension funds retirement system; More market organized (ERISA Act 1974 ; Montagne, 2006)
- Promotion of credit (Fligstein & Goldstein, 2015)
  - Mortgage / Student loans / Credit card (Jorda, Schularick, Taylor, 2014 ; Poon 2009)
  - Subprime crisis as the climax
  - credit scoring as a disembedding technology
- The emergence of a *portfolio society* (Davis, 2009)

Financialization of households

- Inequality mechanisms
  - More dividends for wealthy households
  - More investment opportunities through debt with low interest rates for wealthy households
  - Poor households go into debt and pay high interest rates to the wealthy households who hold securities
  - Financial sector intermediation

Inequality and top incomes as the dependent variable

- World top income database
  - Top 10%, Top 1%, Top 0.1%, Top 0.01%
  - Piketty, 2013 corrections
  - Income only (capital gains excluded)
- OECD inequality measures
  - D9toD5, D9toD1, D5toD1
- Gini (Swiid database)
- 18 OECD countries used (top 1%):
  - Australia, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States
- Period : 1970-2012

Model

Panel model

$Inequality_{it} = financialization_{i(t-1)} + Controls_{i(t-1)} + g_i + a_t + error_{it}$

Country and time fixed effects:

- Explanation in terms of evolutions
- Common business climate captured by time fixed effects

One year lagged independent variables

- =>Better causal interpretation

Panel robust standard errors (Beck & Katz 1995)

Base model: the sector approach

- Financialization = Increase in the share of finance & insurance to GDP
  - Control for GDP, union rate and import rate
- Financialization effect is higher for explaining inequality at the top of income distribution.
- 1 standard-deviation (intra-country) of finance => 0.23 standard-deviation of top 0.1% share and 0.4 s.d. of top 0.01% share

Table 1. Impact of the finance share of the GDP on income inequality

	Gini Index	D5/D1	D9/D1	D9/D5	Top 10% share	Top 1% share	Top 0.1% share	Top 0.01% share
GDP per capita (t-1)	-0.51***	0.62***	0.34**	0.13*	-0.21*	0.04	-0.02	0.02
Union rate (t-1)	-0.27***	-0.16**	-0.23***	-0.25***	-0.36***	-0.23***	-0.1**	-0.14***
Import rate (t-1)	-0.15***	0.41***	0.17*	-0.03	-0.11**	-0.13**	-0.15**	0.17*
Finance & insurance/GDP (t-1)	-0.04	-0.04	0.16**	0.18***	0.12***	0.23***	0.28***	0.41***
Adj. within R2	0.150	0.081	0.086	0.152	0.174	0.147	0.127	0.229
Nb. obs./ countries/ years	673/18/42	391/18/42	391/18/42	391/18/42	604/18/42	623/18/42	538/17/42	368/14/42

Which variety of financialization counts the most?

Non-finance firms financialization don't impact much inequality

- Dividends could have a modest effect as in Dünhaupt (2014)
- No effect or negative effect of non-finance firms bankarization. Contrarily to Lin & Tomaskovic-Devey 2013

Table 2. Impact of non-financial firms' financialization on income inequality

	Finance /GDP	Gini Index	D5/D1	D9/D1	D9/D5	Top 10% share	Top 1% share	Top 0.1% share	Top 0.01% share
1 Corporate debt / GDP (t-1)	0.17***	-0.03	0.13*	0.09	0.04	-0.07*	0.01	0.05 ·	0.05
Nb. obs./ Countries / years	563/16/42	600/16/42	373/16/42	373/16/42	373/16/42	536/16/42	555/16/42	503/15/42	384/13/42
2 Net distributed income / Operating surplus (t-1)	-0.71***	0.01	-0.01	-0.1 ·	-0.1 ·	0.16*	0.16 ·	0.13	0.15 ·
Nb. obs./ Countries / years	289/15/42	304/15/42	224/15/30	224/15/30	224/15/30	266/15/42	280/15/42	226/13/42	150/10/42
3 Fin. income/Operating surplus (t-1)	0.08	-0.12*	-0.36***	-0.33***	-0.09	-0.4***	-0.3***	-0.23**	0.07
Nb. obs./ Countries / years	289/15/42	304/15/42	224/15/30	224/15/30	224/15/30	266/15/42	280/15/42	226/13/42	150/10/42
4 Financial assets/ GDP (t-1)	-0.09	-0.17 ·	-0.3***	-0.16*	0.04	-0.35***	-0.19***	-0.15 ·	-0.18 ·
Nb. obs./ Countries / years	267/16/23	287/16/23	236/16/23	236/16/23	236/16/23	260/16/23	260/16/23	225/14/23	165/11/23

Households financialization counts more than that of non-finance firms

- Household debt and moreover intermediated finance (mutual funds) count more than the direct ownership of financial securities

Table 3. Impact of households' financialization on income inequality

		Finance /GDP	Gini Index	D5/D1	D9/D1	D9/D5	Top 10% share	Top 1% share	Top 0.1% share	Top 0.01% share
1	Shares and other participations without mutual funds/ GDP (t-1)	-0.29***	-0.25**	-0.16*	-0.25***	-0.24***	-0.18***	-0.04	0.06	0.1
	Mutual funds/ GDP (t-1)	0.1	0.41***	0.3***	0.55***	0.5***	0.07	0.11*	0.17**	0.36***
	Nb. obs./ Countries / years	245/15 /23	263/15 /23	219/15 /23	219/15 /23	219/15 /23	238/15 /23	238/15 /23	211/14 /23	155/11 /23
2	Household debt/ GDP (t-1)	0.52***	0	0.1	0.29**	0.27***	0.03	0.11*	0.17***	0.17**
	Nb. obs./ Countries / years	563/16 /42	600/16 /42	373/16 /42	373/16 /42	373/16 /42	536/16 /42	555/16 /42	503/15 /42	384/13 /42

Market activities rather than classical credit activity

- Traded volume has a strong impact as in Dünhaupt (2014) and Kus (2012)
- Similarly the growth the assets sides invested in financial securities as in Kus (2012)

Table 4. Impact of financial sector securitization on income inequality

	Finance /GDP	Gini Index	D5/D1	D9/D1	D9/D5	Top 10% share	Top 1% share	Top 0.1% share	Top 0.01% share
1 Volume of stocks traded to GDP/ GDP (t-1)	0.39***	0.1*	-0.06	0.18*	0.22***	0.24***	0.28***	0.3***	0.49***
Nb. obs.	356/18/23	385/18/23	308/18/23	308/18/23	308/18/23	355/18/23	355/18/23	285/15/23	206/12/23
2 Loans in asset/ GDP (t-1)	0.42***	-0.07	-0.05	-0.06	-0.05	-0.14 ·	-0.06	0.18**	0.08
Shares and related equity assets / GDP (t-1)	0.12	0.31**	-0.08	0.15	0.26*	0.14*	0.17*	0.43***	0.61***
Nb. obs.	267/16/23	287/16/23	236/16/23	236/16/23	236/16/23	260/16/23	260/16/23	225/14/23	165/11/23

Overall view

- Sample reduced due to loopholes in data
- Household financialized collective savings=> intermediary inequality
- Household debt effect disappears once controlled for marketization
- Traded volume and shares in banks' assets=> gaps between income elites and the rest

Table 5. Overall view

	Finance /GDP	Gini Index	D5/D1	D9/D1	D9/D5	Top 10% share	Top 1% share	Top 0.1% share	Top 0.01% share
Household participations in mutual funds/ GDP (t-1)	-0.12	0.28***	0.38***	0.43***	0.24**	-0.08	-0.01	-0.01	0.15*
Household debt / GDP (t-1)	0.18 ·	-0.08	-0.28**	-0.14	-0.03	-0.21**	-0.12 ·	0.04	0.39**
Volume of stocks traded/ GDP (t-1)	0.39***	-0.08	-0.12	0.18 ·	0.38***	0.22**	0.28***	0.24**	0.21 ·
Shares and related equity in banks' assets / GDP (t-1)	0.26**	0.14	-0.3***	-0.01	0.24**	0.04	0.19*	0.44***	0.66***
Nb. obs./ countries/ years	245/15 /23	263/15 /23	219/15 /23	219/15 /23	219/15 /23	238/15 /23	238/15 /23	211/14 /23	155/11 /23

Summary of findings

- Financialization foster the growth of inequality, especially at the top of the income distribution
  - Financialization of non-financial firms not tied to the increase in inequality
  - Financialization of households through mutual funds and debt tied to the increase in inequality
    - But impact at the top mainly through their impact on the financial sector, especially via marketization
- Financialization or marketization?
  - Marketization as the growing social energy devoted to the trade of financial securities
  - Strongly impacts inequality, especially at the top.
  - How? Via financial wages
  - What's specific to financial markets labor markets? Superstars? Hold-ups?

Interpretation
The importance of hold-ups in finance

A case of hold-up (Godechot 2008)

- 17 millions for a head of trading room and his deputy at Neptune Bank in early 2001.
- A contract
  - Resignation of the 2 for a German rival bank
  - 48 hours given to their bank to match the rival offer
  - Formula 8,5% + 6,5% of the bonus pool
  - On the eve of a major Securities Transaction
- A great year in 2000

A well done negotiation

- *Timing*
  - Exploiting the feeling of urgency linked to the securities transaction.
- *Choice of the bank*
  - Secret
  - Not involved yet in equity derivatives
  - Credibility.
- *Percentage*
  - Benefiting from the growth of money invested without being affected by the growth of headcount
  - Rate used in the formula would probably be applied on very different pools.
  - Remains acceptable for the bank (short term profit not diminished)

A well done negotiation (2)

- *Overall context*
  - Very good economic conditions for the following year. But probable reversal.
  - Leveraging the frenzy of *last-movers*
  - Without taking the risk of going with *last-movers*
- *Resigning together*
  - Resignation : signal of determination
  - Collective. Difficult to replace
  - Social Capital. Credible threat to take their whole team with them

=>A sense of *kairos*.

The mechanics of hold-up

- Appropriation of the firm's key assets
  - The "talent" of the financial worker is not innate.
  - Progressive accumulation of "talent" through the accumulation of financial experience
  - Financial experience. Appropriation of key assets collectively produced
    - Knowledge
    - Know-how
    - Customer Relations
    - Team work
- From appropriation towards the test of strength
  - Legitimization : Forgetting the collective origin and claim for profit
  - Taking advantage of an external offer in order to renegotiate
  - Credible threat of moving part of key assets and part of the activity

Types of collective moveable assets

- Physical capital
  - Computers
  - Software
  - Documentation
- Human capital
  - Knowledge (Traders, sales)
  - Know-how (traders)
  - Financial secrets (arbitrage techniques, etc.)
- Social capital
  - Client relationships (especially sales, M&A, Private equity)
  - Reputation (financial analysts, M&A)
  - Teams (head of…)

What do we know and what do we know less?

- A rent sharing mechanism on the financial market
  - Superstar and winner-take-all mechanisms :
    - Rosen (1980), Gabaix and Landier (2008), Célérier (2012)
  - Asset appropriation and hold-up: Godechot (2008)
- Long term maintenance of the rent
  - Deregulation and limited competition
  - Hold-up mechanism compatible with the transfer of all the rent to wage earners

Thank you!
Questions ?

More by email:

Olivier.Godechot@sciencespo.fr

More in papers:

-- 2016 (forthcoming), *Wages, Bonuses and Profit in the Financial Industry. The Rise of the Working Rich*, Routledge.

-- 2016 (forthcoming), « Financialization is Marketization ! A Study on the Respective Impact of Various Dimensions of Financialization on the Increase in Global Inequality », *Sociological Science*.

-- 2012, « Is finance responsible for the rise in wage inequality in France? », *Socio-Economic Review*, vol. 10, n°2, p. 1-24.

-- 2008, « "Hold-up" in finance: the conditions of possibility for high bonuses in the financial industry », *Revue française de sociologie*, vol. 49, Supplement Annual English Edition, p. 95-123.