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Transfer: European Review of Labour and Research 2009 15: 189

DOI: 10.1177/102425890901500204

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Financial capitalism and private equity – a new regime?

Andrew Watt* and Béla Galgóczi*

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Summary

This introductory article reviews the key issues involved in the debate about the financialisation of the economy. It briefly describes a number of key features at the level both of national economies, such as the growth of the financial sector, and of individual firms, such as changes in the way profits are used. It discusses their interrelationships with outcomes such as increasing debt levels and rising inequality. The article then focuses on private equity, describing its business model, charting its rise in Europe, and reviewing the available evidence on the performance of the firms taken over by private equity funds and the pay, conditions and job prospects of the workers they employ. The article concludes by considering the implications of the current financial and economic crisis for the possible future development paths of financial capitalism.



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Sommaire

Cet article d'introduction présente un panorama des principales questions posées par le débat sur la financiarisation de l'économie. Il décrit brièvement plusieurs caractéristiques principales à la fois au niveau des économies nationales, telles que la croissance du secteur financier, et au niveau des entreprises, par exemple l'évolution de l'utilisation des bénéfices. Il examine leurs relations réciproques et leurs implications, comme l'accroissement des niveaux d'endettement et le renforcement des inégalités. L'article s'intéresse ensuite aux prises de participations privées, décrivant leur modèle économique, relatant leur essor en Europe et analysant les données disponibles sur la performance des sociétés rachetées par des fonds de placement du secteur privé et les perspectives en matière de rémunération, de conditions de travail et d'emploi de leurs travailleurs. Pour conclure, l'article s'interroge sur les implications de la crise financière et économique actuelle sur les voies que pourrait emprunter à l'avenir le capitalisme financier.



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Zusammenfassung

Dieser einleitende Beitrag liefert einen Überblick über die Schlüsselthemen in der Debatte über die Finanzialisierung der Wirtschaft. Er fasst eine Reihe wesentlicher Merkmale der Volkswirtschaften (z.B. das Wachstum des Finanzsektors) und individueller Unternehmen (z.B. Änderungen bei der Verwendung von Gewinnen) zusammen und stellt ihre Beziehungen zur Erhöhung der Verschuldung und zu den zunehmenden Ungleichheiten dar. Der Beitrag befasst sich dann mit dem Thema *Private Equity*. Nach einer Beschreibung seines Geschäftsmodells und seiner Entwicklung in Europa wird auf vorliegende Fakten über die Leistung der von *Private-Equity-Fonds* übernommenen Unternehmen und die Lohn- und Arbeitsbedingungen und Beschäftigungsaussichten der dort beschäftigten Arbeitnehmer eingegangen. Abschließend werden die Folgen der aktuellen Finanz- und Wirtschaftskrise für die mögliche künftige Entwicklung des Finanzkapitalismus aufgezeigt.



Keywords: financialisation, private equity, inequality, debt, financial crisis, activist investors, regulatory reform

Introduction

Financialisation is a term used to describe a process of structural change within capitalist economies and societies in which the role of finance becomes increasingly dominant, leading to an ‘increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies’ (Epstein 2005: 3). Financial capitalism is a term that describes a state, one in which the process of financialisation has gone so far that the role of financial motives, markets, actors and institutions can be considered predominant.

Academics, but also policy-makers, have started to examine the contours of these structural changes as part of a broader debate about changes in, and the future of, capitalism. This debate has intensified with the outbreak of the global economic crisis in 2008, widely seen as having been precipitated by pathologies in the financial sectors of advanced economies.

This introductory article sets the scene for the following articles in this special issue of *Transfer*, which focus on one key aspect of financialisation, the rise of private equity. In the next section we review some of the main features of financial capitalism. Most of the literature refers to the case of the US (with occasional references, in Europe, to the UK). Where possible we provide some data on (western) Europe. The third section provides an overview of the debate on private equity in Europe, as one

key manifestation of the trends towards financial capitalism. We describe its mode of operation and review the evidence on its impacts. In a final section we reflect on the implications of the economic crisis and consider whether the financialisation trend will now be reversed or rather change its form.

Structural features of financial capitalism

Financialisation or financial capitalism is characterised by a range of interlocking phenomena. The most important of these are set out in this section, as they provide important background information for the discussion in this and the following articles of private equity and also to the discussion on the economic crisis. This interlocking nature, and the fact that research is at a comparatively early stage, and the nature of some of the linkages is incompletely understood, if not speculative, make it difficult to structure this discussion. We consider characteristics of a more ‘macro’ (total economy) nature in the next sub-section and those of a more ‘micro’ (firm level) nature in the following sub-section, while being aware that this distinction is somewhat arbitrary at times.

Features at the macro level

Financialisation manifests itself at the macro level in a number of different ways. Most of the existing studies refer to the USA (Epstein 2005; Skott and Ryoo 2008; Palley 2008; Stockhammer 2004: 114 ff; van Treeck *et al.* 2007). Unfortunately the data situation for the European Union is rather poor, with detailed reporting for individual countries and EU aggregates often available for periods that are too short to distinguish between structural and purely cyclical or otherwise transitory trends. Some of the main trends are described here with EU data where available, otherwise with reference to individual countries.

The most obvious feature of financialisation is the increasing size of the financial sector. Figure 1 (below) shows that the overall financial sector (FIRE = financial services, insurance, real estate and business services) has almost doubled its share of output in the EU-15 over a 30-year period since 1975, with a parallel increase in employment (here: total working hours); the fact that employment shares are much lower than output shares indicates substantially higher than average labour productivity in this sector. For financial intermediation (FI), the financial sector in the narrow sense of ‘banking’, this is indicated by the line (with markers, plotted on the right-hand axis) showing productivity between 1.5 and 2 times the average, with a notable surge after 2000.¹

1 The flat employment trend reflects an expansion of high-skilled financial jobs and the simultaneous loss of many semi-skilled banking jobs through automation.

Figure 1: Relative size of financial sector as a percentage of total economy, EU-15

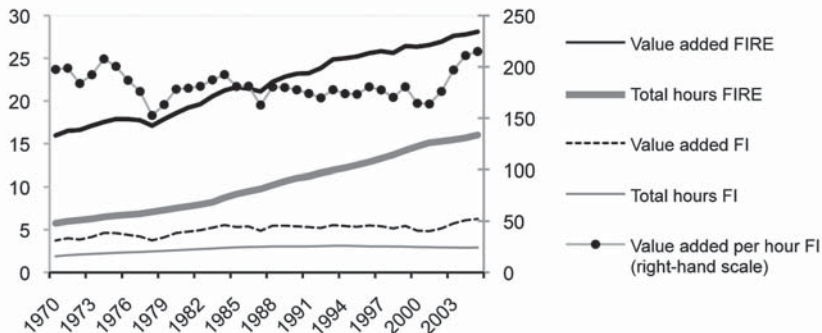
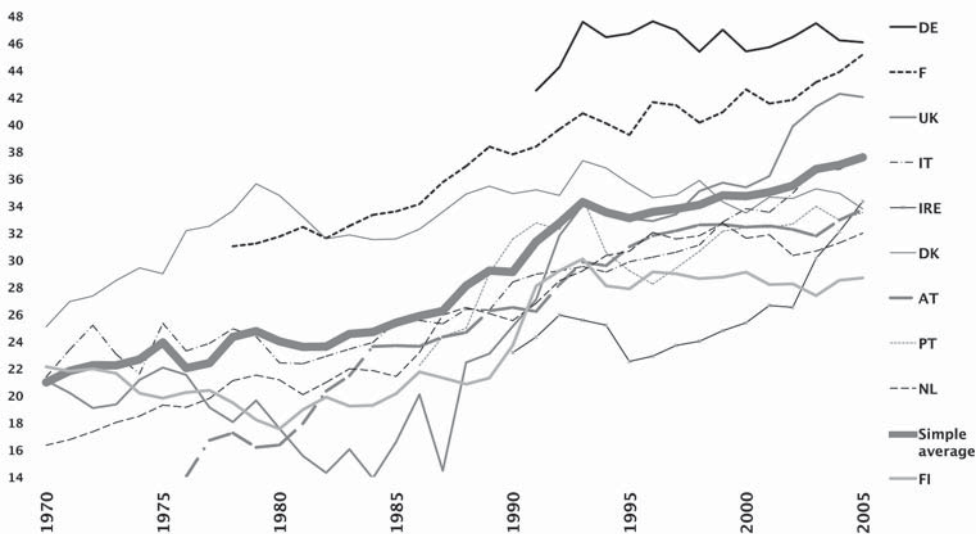


Figure 2: FIRE profits as a percentage of total economy



Source: EU KLEMS database, own calculations.

Alongside this there has been a very substantial increase in the share of total profits going to financial companies. This is particularly the case in the USA. Palley (2008: 13) calculates that US financial sector profits were a quarter of those in the non-financial sector in 1973 but almost one half in 2000. As Figure 2 shows for a selection of EU-15 countries² the (broad) sector’s share of profits has shown an upward trend since the early 1980s. The unweighted average of these countries rose from 21% in 1970 to 36% in 2005.³ The same

2 Unfortunately data are not available for the EU-15 as a whole. No data are available for Luxembourg and only shorter time series are available for Belgium, Greece and Sweden. The data for Portugal for several years prior to its EU accession in 1986 seem anomalous and were excluded.

3 This result is not noticeably affected by the changing composition of the group of countries over time. The simple average of the entire group of 11 countries increased from 30% in 1991 to the final figure of 36%.

is true of financial intermediation where the average rose from 4% to 7% of the total by 2005 (and certainly increased further during the recent boom until 2008).

These figures were reflected in substantial increases in the volume and also the range of financial products offered by financial corporations to households, non-financial firms and, not least, to each other. Volumes of traditional financial products such as shares and corporate bonds have risen extremely rapidly (measured as a share of GDP). Even faster has been the increase in the volume of transactions, as electronic trading bourses have driven down transaction costs and opened up previously national financial markets to international trading. This has facilitated the taking of short-term speculative positions and led to the rise of new actors, notably hedge funds, seeking to profit from small anomalies between prices in markets for different products or in different countries.

At least as important as technological changes, however, were political ones. Lobbying by the financial industry and competition between financial jurisdictions led to deregulation and the lowering of the supposed 'burden' of supervision and reporting obligations. Restrictions on the types of assets that different sorts of fund could invest in were progressively relaxed, as even supposedly 'conservative' insurance companies and pension funds sought higher returns from the exciting new (and not so new) products.

As part of this process a whole new range of financial products has been created. On the one hand these enable market actors to 'hedge' (offset) certain risks. A company can hedge the risk of future changes in energy prices or exchange rates by buying options today at a known price. A credit default swap offers a form of insurance against the risk of a company defaulting on a bond in a portfolio. So-called securitisation – the repackaging of formerly untraded contractual relationships, such as mortgages and other loans, and their selling-on to other investors – enabled market participants to diversify their risks (e.g. Frank and Krahen 2008).

It was already known before the crisis that such increasingly complex transactions entailed risks of their own. The volume of such transactions far exceeded what was necessary for hedging real economic activities. Increasingly such efficiency-enhancing and risk-reducing trades gave way to a frenzy of speculation in an alphabet-soup of so-called 'structured' products: these are traded on a stock exchange and link the return on an investor's principal to the performance of an underlying security, such as a stock or package of mortgages. Many of those who bought such products had no material interest in the underlying corporate bond, mortgage loan or stock. The selling-on of risk led to misaligned incentives on the part of those originating the underlying contracts, in particular to misrepresentation of the nature and extent of risk to ill-informed consumers; ownership of various securities (and of the attendant risks) became virtually impossible to trace and thus to monitor; purchasers of such products tended to put their faith in rating agencies which have a quasi-legally institutionalised oligopoly and are paid by product-issuers (and not purchasers).

This complex mix of institutional and other changes gave rise to two interrelated outcomes: an increase in the availability of and willingness to take on debt and a succession of booms and busts in asset prices such as real estate and shares, and some other prices (notably exchange rates and commodity prices).

Both households and companies took on increasingly large amounts of debt relative to income and their capital respectively. Some figures are available for the euro area (ECB 2009: 47 ff): household borrowing was growing at 6% a year in the early 2000s, rising to a peak of 10% in 2005; household debt increased from around 48% to around 60% of GDP (2001-08). Meanwhile the debts of non-financial corporations rose from around 60% to 80% of GDP (and roughly from 300% to 400% of profits) over the period 1999-2008 (see also below). However, these increases are considerably below those reported in the USA, the UK and some individual euro area countries characterised by housing bubbles (for US data see Skott and Ryo 2008; for the US and Germany see van Treeck *et al.* 2007; ECB 2009: 49).

The increase in debts was in turn fuelled by the purchases of assets (in the case of households in many countries especially housing but also shares and other financial assets). The resultant housing and other asset price bubbles increased actors' collateral and encouraged further borrowing and speculation. The seeds were sown for a classic sequence of financial boom and then bust.

Differences in countries' financial systems along with other (also cultural) factors led to differences in access to credit, to the size of bubbles. This in turn led to huge increases in indebtedness between countries. Countries in which consumption expanded rapidly (US, in Europe UK, Ireland, Spain and some eastern European countries, especially the Baltics) sucked in imports. Unlike in previous times they were able to run persistent and large current account deficits, supplied by goods and capital from surplus countries (notably China, Japan and Germany). These global imbalances in turn interacted with speculation to produce large swings in exchange rates. (For more on the interactions between global and domestic imbalances see Buiter 2009; Blanchard 2009; Watt 2008.)

A final feature of financial capitalism that should be mentioned at the macro level is widening inequality (OECD 2009; Palley 2008; Watt 2009). A steady decline in the share of wages in national income and a major widening of pay differentials within wage- and salary-earners⁴ are stylised facts of economic development in the advanced capitalist countries since the early 1980s. This reflects changes broader than those relating to the financial sector discussed here, and notably globalisation and probably also technological changes (e.g. Gordon and Dew-Becker 2008). Still, financialisation has exacerbated income inequality by generating huge income gains for owners of financial

4 The former more pronounced in continental Europe, the latter more in the English-speaking countries.

(and also real) assets, who already tended to be relatively wealthy, for the ‘masters of the universe’ on Wall Street and the City of London and their top staff, and more generally for CEOs and top managers of companies generally. This leads on to the changes wrought by financialisation at company level.

Features at the micro level

Financialisation transforms the functioning of the economy on both the macro and micro levels. From a microeconomic perspective, key financialisation issues are about capital access and control, determining how enterprises are managed and the ways that corporations are governed.

As part of the financialisation trend the Anglo-Saxon interpretation of corporate governance, which puts the interest of capital owner or shareholder in the centre and sees the measure of success and the criterion of good corporate governance in the maximisation of shareholder returns gained widespread popularity in management literature. In many continental European countries, the predominant ‘Rhineland’ capitalism had been based for a long time on a broader set of actors and interests (creditors, especially banks and employees) all of which had a longer investment horizon in terms of their commitment to the firm. This was often labelled as a form of capitalism based on patient capital (Albert 1992, 2001).

As the dominant form of capital access for firms shifted from bank credits to financing by capital markets, shareholder-value orientation gained more importance, driven also by the globalisation of financial markets, increasing cross-border capital flows, mergers and takeovers. This trend, together with deregulation measures, has helped the Anglo-Saxon shareholder-centred corporate governance model to gain a major influence over alternative models of corporate governance, as e.g. in continental Europe or Japan (Vitols 2008).

Seen in a historical perspective, manager capitalism followed family based capitalism and gave way more and more to ‘financial market capitalism’ (Windolf 2005).

Within managerial capitalism, the relationship between firms and financial markets had been thematised in the form of an ‘agency problem’ (Jensen and Meckling 1976). The major issue here was how to align the interests of firm managers (agents) with those of shareholders and financial market participants (principals). Corporate governance was seen as a tool to make sure that employed managers do not pursue their own particular interest in decisions, nor take account of any other stakeholder interest (such as employees or creditors) but pursue the sole interest of shareholders. The agency approach has thus posited the sole purpose of corporations as to maximise shareholder returns. In order to control and motivate managers to achieve this end,

their compensation was increasingly linked to short-run movements in the share price, notably by means of stock options.

Another way of solving the agency problem was the emergence of activist investors that took a direct control over the management of companies, rather than the traditionally more passive role taken by institutional shareholders such as pension funds. This new type of ownership raises the influence of those institutional investors, banks, insurance companies, financial conglomerates, pension funds and other funds like private equity funds and, sometimes, hedge funds taking a hands-on approach.

This trend was most apparent in the shift in the ownership structure of listed companies. While in 1965 only 10.5% of the shares of listed US companies were held by investment funds, this ratio had increased dramatically to 66.1% by 2005. In the case of Germany, where enterprises were traditionally under control of banks through a diverse network of cross-ownership (often referred to as 'Deutschland AG'), the role of investment funds also became decisive. For the 30 largest listed German companies, the share of investment funds in their total equity reached 76% in 2007, of which 54% was held by foreign funds (Windolf 2008).

At the same time the fall in transaction costs mentioned in the previous section increased the prevalence of short-term shifts in portfolios, making corporate finance more dependent on the vagaries of (potentially volatile) market sentiments. Financial market capitalism – from a micro perspective – may therefore be defined as a specific capitalist regime where enterprises are more and more dominated by the operational principles of the financial markets.

With the growing complexity of economic and financial transactions, supported by technological change (IT technologies above all) and globalisation, the detachment of financial transactions from material (real economy) operations has accelerated. This led to 'transaction-based financial capitalism' replacing the earlier 'relationships-based financial capitalism' as the mainstream model (Buitter 2008). What matters here is the logic of financial transactions where the value and the short-term increase of the investment portfolio is the sole criterion, with selling and buying being the core activity. With the emergence of abstract financial products and techniques it is no longer necessary to be in possession of the investment object in order to realise profit on its sale. Links and relationships to creditors, business partners and employees who previously appeared also in personal relationships (there were faces behind the transactions) no longer matter.

Although activist investors invest directly into 'the real economy' gaining influence over companies in different stages of their life cycle, they are not motivated by the sustainability of individual companies, instead what matters is the value of their total portfolio. In cases where a splitting up of companies brings more value for the

portfolio, as e.g. through sales of valuable real estate, even if this brings the destruction of individual companies with it, the total value of the portfolio may well rise. These are archetypes of ‘unrelated’ acquisitions as buyout firms typically manage their portfolio companies completely independently from one another. This form of takeover is not motivated by potential advantages from the integration of the acquired entity into another entity (‘synergies’), but by the intention to increase the value of the takeover target as a stand-alone business beyond the purchase price (Baker and Montgomery 1994).

Activist investors exert a profound influence on the economy as whole, including effects on those companies which remain under traditional ownership whether privately held or publicly listed. Takeovers and the threat of takeovers also have a great impact on the operation and management of potential target companies. It has become a standard argument by managers to optimise decisions for the continuous increase of the share price that otherwise might be threatened by a hostile takeover. The threat of takeover – real, perceived or a pure excuse – is often used to justify restructuring measures (e.g. massive lay-offs) that are not otherwise required by economic fundamentals. This ‘market for corporate control’, i.e. a market on which the right to manage a company can be bought and sold, induces major shifts in general company behaviour that manifests itself in higher profit expectations and growing short-term orientation. Deregulation played a crucial role here, where the ‘one share, one vote’ principle became the leading doctrine, forcing companies to remove rules to maximise control rights of individual shareholders.

Further concerns are related to the corporate governance model of activist investors, above all, financing of buyouts with a high leverage, which means putting a huge debt burden on portfolio firms thus narrowing their development perspectives (see next section).

Some authors argue that on basis of financial theory there is no optimal capital structure – the choice of equity or debt financing is irrelevant, there is no ideal level of debt from the owners’ point of view, dividend policy is also neutral, there is no optimal level or timing of dividends (Schmidt and Spindler 2008). However, such theories rely on very restrictive assumptions about the efficiency of capital and other markets. In practice, a high debt burden on companies, with early dividend payments to investors, narrows the range of possible managerial decisions. This can have the positive effect (from the shareholder’s point of view) of forcing them to focus on highly profitable investment (rather than on, say, maximising the growth of the company). However, it also raises the default risk and may increase the focus on short-term rather than longer-term goals (Vitols 2008).

Their short-term investment horizon, a frequently raised argument against activist investors and private equity (see below), is often seen in relation to public listed

companies, where management decisions are driven by quarterly reporting and thus tight share price related performance measurement. This relative 'advantage' in the investment horizon does not diffuse the basic concern of tight and short-term shareholder control.

The articles in this issue of *Transfer* highlight many of the above-mentioned concerns with regard to activist investors and the impact of PE-controlled firms and their employees by reference to concrete examples and case studies. In the next section we provide an overview of private equity activities in Europe.

Private equity

The involvement of private equity funds in buying, restructuring and selling companies is perhaps the most visible form of financialisation, and certainly the one with which organised labour is most likely to have come into direct contact. Here we provide an overview of the private equity phenomenon from a European perspective. This section draws heavily on previous more extended work by one of the co-authors to which the interested reader is referred (Watt 2008).

Business model

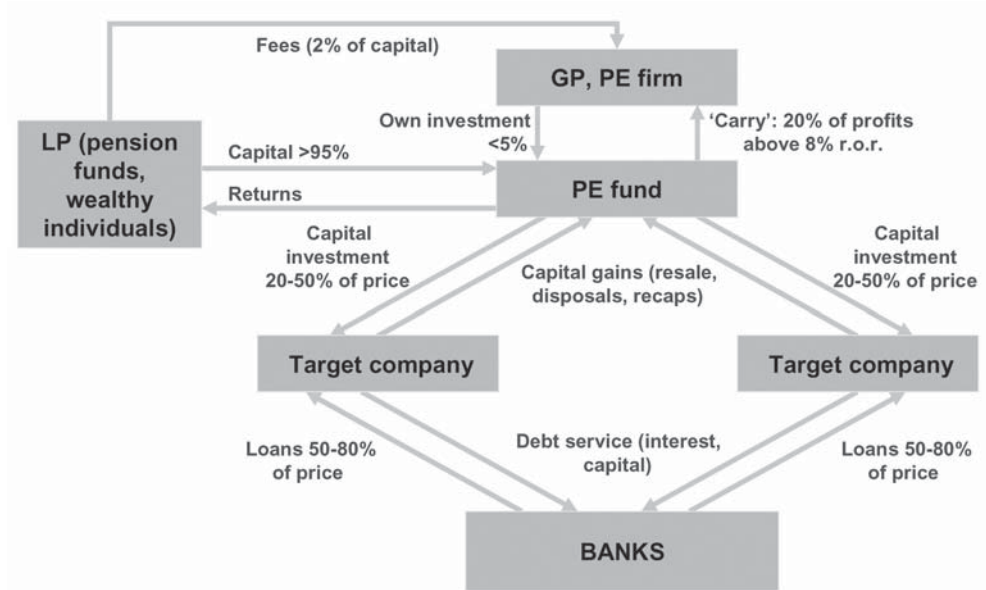
The basic *modus operandi* of PE firms is summarised in Figure 3. The PE firm is set up by a (usually small) number of individuals or in some cases as an offshoot of a larger financial organisation, such as a bank.⁵ These PE firms then launch one or more PE funds. They invest a relatively small amount of own capital into the fund – typically less than 5% of the value of the fund – and take the position of general partner (GP) in the fund.

The first task is to raise capital for the fund. Investors – who provide the remainder (typically >95%) of the fund's capital – are attracted to commit their money by the promise of high returns. The track record of the fund managers and/or of the PE firm is used as a guide. Investors consist of pension funds, banks, insurance companies and wealthy individuals.⁶ They are termed limited partners (LP).

5 To give an idea of the orders of magnitude, the EVCA Directory for 2007 lists around 500 (associate and full) members who are independent general partners and around 130 who are subsidiaries of various financial institutions.

6 In Europe around 50% of the funds are obtained from insurance companies, pension funds and banks. The share obtained from private individuals has fluctuated in recent years between about 5 and 10%, including the contributions of PE general partners to the fund (EVCA 2007: 43).

Figure 3: How the PE business model functions



Note: Authors' conceptualisations; figures are typical values.

The terms of the funds' contract with investors vary but the following arrangement is quite typical. The investors agree to tie up their money for a set period of usually ten years. They pay the fund owners a management fee (often 1.5-2% a year). They receive the earnings from the target company on its resale and intermittently in the form of dividends and other payouts. Above a threshold rate of return (typically 8%), 20% of the earnings are retained by the GPs as so-called 'carried interest'.

The fund's capital is used to purchase ('target' or 'portfolio') companies. Normally each fund has a certain area of specialisation in the size, sector or nationality of the target companies it buys up. If the target company is listed in the stock exchange, an offer is made for the shares and the company is de-listed ('taken private'). In the case of privately-owned companies a purchase is negotiated with the owners. In the former case PE firms are obviously looking for companies whose current share price, for whatever reason, is low compared to its potential value, or for privately owned companies whose owners wish to 'cash out' or that are underperforming and thus cheap relative to their potential resale value. Companies are bought and/or invested in until the monies in the fund are exhausted.

Of the money needed to buy the target companies only a proportion (normally between 20 and 50%) is provided by the fund itself. The rest is borrowed from banks, using the assets of the target companies as collateral for the loans. This means that the target

companies have to produce a stream of revenue (out of profits) with which to service these loans. They therefore tend to be more highly leveraged (have a higher debt-to-equity ratio) than non-PE-owned companies. Using more debt can be tax efficient (because interest payments are tax deductible while dividends are not) and leverage has a magnifying effect on returns, but also on losses. In the case of a good investment (or in ‘good times’), returns can be very high, whereas if restructuring is unsuccessful (or times are generally bad) the risks of bankruptcy are magnified.

The PE fund then runs the target companies with an explicit view to their resale (‘exit’) after a limited period, typically three to five years. In some cases the existing management is retained. In others external managers are put in place.⁷ The target companies are run with a view to maximising the return to the new owners (the PE fund) over the lifetime of its engagement. PE’s exit takes one of two basic forms: either the target company is listed (or re-listed) on the stock exchange, and shares are offered to the public in an initial public offering (IPO). Or a strategic buyer (normally a company in the same or a related sector) is sought. As a variant on the latter, the target company is sometimes bought by a second or even third PE fund, seeking value not yet extracted by the first fund (secondary buyout).⁸

The main source of the return to the PE fund is a capital gain, that is the difference between the purchase and sale price of the company, after allowing for the costs of any additional investment and revenues from divestment (sale of assets). In addition the fund benefits from dividend payouts. Particularly controversial are so-called ‘dividend recapitalisations’ where money is borrowed against the target firms’ assets in order to finance an early payment to investors. In some cases the PE fund also charges the company various consultancy and management fees.

The growth of PE in Europe

Figure 4 shows data – from the European Private Equity and Venture Capital Association (EVCA), the trade body of the PE industry in Europe – for the two key indicators of the ‘size’ of the PE industry⁹: the amount it invests and the amount it raises in capital. Investment rose from around €10bn in 1997 to almost €40bn in 2000, before weakening in response to the cyclical downturn. Beginning in 2005 there was a rapid acceleration in investments, to around €75bn by 2006. While

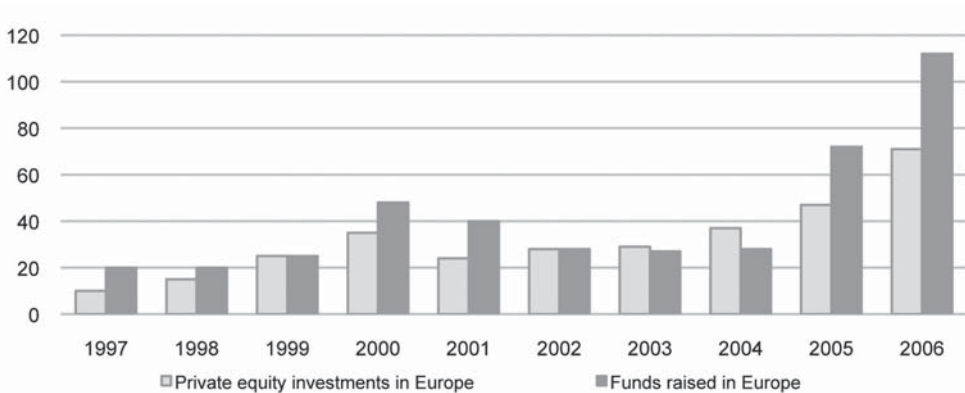
7 According to a survey of large buyouts, 68% led to changes in top management in Europe and 74% in the US (Ernst & Young 2008: 7).

8 In the large sample of LBOs examined in WEF 2008 (with a US and UK focus) IPOs accounted for 13% of exits, 39% were sold to another corporation and 24% to another PE firm (WEF 2008: viii, 18), the remainder being accounted for by ‘unknown’ bankruptcy and other sales (e.g. to management).

9 The EVCA figures are probably the most comprehensive available for Europe. It should be noted that they also include venture capital (investment in start-ups), although this is of limited quantitative importance: ‘seed’ and ‘start-up’ investments accounted for 10.6% of funds invested in 2006 (EVCA 2007: 49).

following a similar trend (funds dispensed have first to be raised), the development of fundraising was even more dramatic: in 2006 more than €110bn was added to the PE ‘war chest’ in Europe which will be disbursed in the coming years. Data are not yet available to determine how PE fundraising has been affected by the crisis, but given heightened risk aversion a decline is to be expected at least for an initial period (see also the final section).

Figure 4: Private equity investments and funds raised in Europe (billion euro)



Sources: EVCA/Thomson Financial/PricewaterhouseCoopers.

It is important to realise that leverage, which can be up to 4:1 means that PE spending is multiplied by an equivalent amount. Thus an additional €110bn of funds could be translated into target-company purchases totalling €440bn. To put that number in context, it is almost €1000 for every man, woman and child in the European Union of 27.

Evidence on its impacts on portfolio companies

As indicated above, the sharp growth of PE has given rise to concerns in a number of areas. Gradually academic research has begun to try to shed light on the facts. Particularly given the controversial nature of the subject, the restricted access to data, but also various methodological problems when measuring the performance of PE portfolio companies, the findings are often mixed. They can be summarised for the areas jobs, wages and working conditions, worker representation, taxation, short-termism and systemic risk as follows:¹⁰

¹⁰ For a fuller discussion, literature references and reporting of the findings of key studies see Watt 2008: 556 ff).

Job losses: the most comprehensive study to date, commissioned by the World Economic Forum (WEF 2008), provides rather strong evidence that LBO (leveraged buyout) activity results in larger employment losses than in control groups that adjust for factors such as enterprise size and sector. It notes that ‘the net impact on [employment in] existing establishments is negative and substantial’ (p. 53). In the year of the LBO and for the three following years employment losses are on average between 1% and 5% a year greater than in the control group. Overall, after five years employment is a very substantial 10% below the level in the control group. Overall, the weight of the serious academic research seems to point to – at least – an intensified period of restructuring following LBO acquisition in which job losses are substantial, also compared with comparable companies not taken over, suggesting that workers in the average target company pay a high price in terms of job losses.

Cuts in wages and working conditions: Unfortunately the evidence base in this key area is narrow. However, if anything the findings on wages are clearer than for employment effects. Cuts in wages and conditions (absolute or relative to peer groups) do seem to be a frequent occurrence. One study estimated the wage growth was slower by 1% a year, although there are important issues of the appropriate benchmark here if the firms taken over were underperforming prior to acquisition, prevailing wage trends and conditions may not have been sustainable.

Weakening of worker representation: It does not seem to be the case that the PE industry as a whole is launching a wholesale attack on Rhineland capitalism, replacing corporatist structures at company level with Anglo-Saxon managerial unilateralism. Some anecdotal evidence suggests that PE, with its narrow focus on obtaining its operating goals, is often ‘unideological’, if unsentimental, in its approach to issues such as collective bargaining and worker participation.¹¹ What matters is the expected impact on the return on capital. Worker representation institutions will come under threat, and may be destroyed if they are perceived, rightly or wrongly, as inimical to PE’s goals. But the fund will carefully weigh the likely costs of such action. There are likely to be large differences in the approach taken by different funds depending both on their own traditions and the specifics of the country and sector the portfolio company is operating in. Negative impacts can certainly appear as existing rules of the game are changed by undermining the longstanding and trust-based relationships within the company’s structures (for examples see the articles by Kädtler and Chambost *et al.* in this volume).

Taxation: This is the issue on which the evidence of the deleterious effects of the PE business model on other stakeholders – in this case taxpayers – is most clear-cut. National taxation systems seem to privilege the PE business model in a discriminatory

11 At a recent meeting attended by the author, a union organiser in the US noted that many American owners of family-run firms would rather see ‘their’ company go to the wall than ‘let the union in’. PE, by contrast, would coldly weigh the implications for the bottom line of permitting unionisation and of fighting it.

way in a number of areas. The PE model is clearly tailored to reducing the tax liability of its portfolio companies. Interest payments on bank loans are tax deductible (privileging of debt over equity) in almost all jurisdictions. Much income of GPs is taxed as capital gains at much lower rates than earned income (typically 10-15% vs. 35-45%). The effects of the creative use of such tax breaks can be substantial. Governments have woken up to this fact and some changes, at least, are under way, with taxation the major focus of legislative and parliamentary activity linked to PE in the OECD countries (Evans and Hubbard 2008: 72).

Short-termism: Perhaps the most difficult area to assess is the claim, frequently, made, that PE firms are run with a view solely to short-term results and thus longer-term investment projects are not realised. Given the methodological problems there has been little systematic study of this question. Some studies have found little difference on indicators of sustainability and R&D and investment. There is, however, case-study evidence of such short-termism (also in the following articles in this issue). It may be that short-termism is a broader phenomenon not linked to PE. Indeed taking firms private may be one way to ease the pressures management of listed companies face through quarterly reporting obligations. The argument that firms have to be re-sold and that short-termism is therefore not an option because it will be reflected in the sale price is only superficially persuasive as it relies on capital markets to work efficiently. As the crisis has, at the latest made apparent, this cannot be relied upon.

Leverage and micro and macroeconomic risk: Most pre-crisis studies came to the conclusion that the PE equity industry was too small – as a proportion of the overall financial system – to pose systemic risks. This view is being revised, however, in the light of the financial crisis, which has shown the potential for contagion from one market to another. Also banks are already weakened by the crisis and defaults on loans by PE-owned companies may well blow further holes in their balance sheets. A recent paper by Vitols (2009) suggests that up to half of PE-owned companies in Europe might default on at least some of their debt. The PE funds are not themselves leveraged, however. Investors stand to lose the money they have placed in the funds. This could hit some pension funds hard.

Financial capitalism and the crisis

We conclude this article by reflecting on the current economic and financial crisis. It is clear from the discussion above that the crisis is also a crisis of financial capitalism. The trigger for the crisis was the irresponsible borrowing and lending in the US subprime mortgage sector. It was spread around the world not least by the holdings of opaque 'toxic' assets by the global financial system. The collapse of asset prices, the resultant deleveraging and credit constraints transmitted the virus from the financial to the real sphere. More fundamentally, as we have seen, phenomena associated with financial

capitalism drove actors to take increasing risks, and hide those risks from customers and regulators. They increased debt levels, made companies less resilient, exacerbated inequality and permitted international imbalances to build up. In short, in the boom years financialisation promoted a growth model that was long on unsustainable consumption (in some countries) and short on real investment but created the conditions for the current crisis which has hit real activity to an extent that has not happened in living memory.

A more immediate question now is what will be the impact of the crisis on the future development of financial capitalism. Does the crisis mean that the end of financialisation is at hand and that capitalist economies and societies will embark on a reregulation of their economies, taming the financial sector and refocusing it on providing longer-term investment finance?

At the current juncture it must be said that this is still an open question. It does seem clear that there cannot simply be a return to 'business as usual' after the crisis. Partly this is an endogenous, market-driven correction: the excesses of financial capitalism will not be repeated within a foreseeable time because actors will remain cautious and risk averse even after they have recovered from the extremes of risk aversion which paralysed normal financial transactions. The deleveraging process of paying down accumulated debts will take some years. Imbalances in the world economy will decrease as currencies adjust and – it is to be hoped – surplus countries take steps to stimulate their economies. There will be greater scrutiny of business plans and remuneration packages by owners.

However, these processes by themselves only hold out the promise of a temporary respite: gradually it will, unmanaged, sow the seeds for the next unsustainable boom and bubble, as asset prices rise again and risk appetite returns on the part of both lenders and borrowers. Indeed the very support offered to banks will in the medium run encourage greater risk-taking ('moral hazard') if investors and other actors think they can take risks while relying on the state to pick up the pieces if things go wrong. If this is to be avoided changes will have to be made to the regulatory framework for economic activities in our societies that ensure that private incentives are better aligned with socially desirable outcomes (e.g. Buitter 2009).

What are the chances for regulatory reform?

There is certainly no shortage of demands and concrete proposals for institutional reform. Among many other initiatives the, the so-called G20 group of advanced and emerging countries, the international financial organisations, the OECD and European Commission have made proposals, in particular, to stabilise the financial sector. Guidelines have been drawn up for remuneration codes on conduct to reduce the

incentives for risk-taking and promote longer-term thinking. A UN Commission chaired by Joseph Stiglitz has proposed reforms of the international economic governance structures.¹² In the EU the so-called de Larosière commission has made proposals for reregulation at the European level which the European Commission is proposing to transpose into legislative form.¹³ National governments and central banks have been discussing changes in the areas of supervision and regulation. Trade unions and other actors, for their part, have insisted on the need for a broader package of measures to address, alongside the stability issues in the narrow sense, also the broader issues of social (and ecological) equity and sustainability. Alongside reregulation they have called for changes in taxation regimes, measures to reduce international races to the bottom, and a shift to socially and environmentally more sustainable forms of production. The ETUC, for instance, has called among other things for a New Social Deal for Europe.¹⁴

At the moment politicians and media commentators and opinion formers are echoing these demands for reform. Former champions of deregulation and liberalisation are largely quiet or even proposing regulatory initiatives. The financial sector has benefited from taxpayer largesse to an extent previously considered impossible. Indeed substantial proportions of it are, in many countries, *de jure* or *de facto* in government hands. Under these circumstances it would appear obvious that very substantial regulatory reform is inevitable.

This may not be as obvious as it seems, however. First of all, recent events have shown that, while financial institutions and other companies depend on governments, then the latter also depend on the former. Petrified by the consequences of financial or economic meltdown, governments have been pumping in money first and asking questions later. The IMF calculates that some two-thirds of toxic assets in European banks are not accounted for. In other words, despite all the money pumped into the sector, banks are able to avoid coming clean on the extent to which they are still sitting on toxic assets. Non-financial companies, too, are demanding state support and threatening mass redundancies if it is not forthcoming. It is not clear in such an environment that governments will be able, at national or supranational level to impose their will on companies arguing that they cannot bear any additional regulatory burdens. National initiatives face the longstanding problem of regulatory arbitrage: the threat of companies moving to laxer jurisdictions. Only multilateral avenues seem promising therefore, for regulations that impose serious burdens on companies. Or regulatory reform will be limited to those changes that companies perceive, having learnt some lessons from the crisis, to be in their collective interest in any case.

12 The text of the report is at: <http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf/>

13 The text of the report is at: http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf/

14 See <http://www.etuc.org/a/5838/>

A key issue then becomes the speed at which economic recovery can be expected. At the time of writing there is much talk of green shoots and some tentative signs from leading indicators that the worst may be over. Whether a stabilisation will give way to a recovery worthy of the name, however, is unclear. Most forecasters continue to emphasise the high level of uncertainty and continued downside risks. The risk is that signs of recovery and any actual strengthening of economic growth and confidence will ease the pressure on governments to enact regulatory reforms. It will be claimed that decisive action by monetary and fiscal policy has been enough to remedy the crisis. It will also be claimed that any losses will be quickly recouped and that the longer-term costs of introducing efficiency and innovation-stifling regulations are considerably more important (e.g. Becker and Murphy 2009).

A key issue is what exit strategies governments and central banks will apply when abandoning some of the emergency measures used in addressing the crisis (e.g. intervention or even direct ownership by the state). What elements of the crisis management strategy will be classified as non-systemic short-term reversible measures, and what elements will emerge as long-term features of a new financial-economic order. There will clearly be temptations, assiduously cultivated by certain interests, for a restoration of pre-crisis conditions.

Overall it seems that, for market reasons alone, the overblown financial sector will contract somewhat, in the short run at least, in all leading economies. A window of opportunity does exist for regulatory reform. Reforms that are acceptable to the business community (as a collective actor) and where the risk of individual companies availing themselves of an 'exit option' is limited are likely. Some burdensome reforms to render the system more stable (such as greater capital adequacy requirements, some increases in reporting obligations and supervisory powers) will probably also be pushed through at various levels in the coming months. Yet this window of opportunity is closing quite rapidly.

More fundamentally it seems that technological, lifestyle and other reasons suggest that the importance of financial markets, transactions and actors in our societies is unlikely to decline markedly. It seems more plausible to assume that their forms will shift over time, leading to a permanent 'game' in which governments and other social actors seek to contain financialisation's excesses while channelling its positive dynamic effects to maximise social outcomes, in the face of a constant tendency for individual actors or indeed the sector as a whole to pursue actions that maximise their own rewards but are inimical to broader social goals. What is certain is that this game is likely to be an important if not predominant sphere of social and political debate and conflict in the coming months and years.

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