The Neoliberal Paradox: The Impact of Destructive Product Market Competition and Impatient Finance on Nonfinancial Corporations in the Neoliberal Era

JAMES CROTTY

Department of Economics, University of Massachusetts, Amherst, MA 01003, USA

Abstract

The evolution of financial markets in the neoliberal era has created serious problems for large nonfinancial corporations already harmed by the slow aggregate demand growth and destructive competition of the period. Financial market pressures led to shorter planning horizons, a declining allegiance of stakeholders to long-term corporate goals, and a large increase in the percentage of cash flow paid to financial market agents. The net result is a "neoliberal paradox": financial markets demand that corporations achieve ever higher profits, while product markets make this result impossible to achieve. The neoliberal paradox helps explain the outbreak of financial accounting fraud in the late 1990s.

JEL classification: *F02; G1; G3*

Keywords: *neoliberalism; financialization; corporate governance*

1. Introduction

The emergence of the global neoliberal economic order has had a number of negative effects on general economic performance. I focus here on its effect on large U.S. nonfinancial corporations (NFCs). I accept the thesis associated with Joseph Schumpeter ([1943] 1976) and Alfred Chandler (1990) that large NFCs operating in oligopolistic markets were the main source of most of the capital investment, technological change, and productivity growth in the Golden Age. I argue that NFC performance was adversely affected by two

Author's Note: I am grateful to the Political Economy Research Institute of the University of Massachusetts, Amherst, for generous research support; to Alper Duman and Ozgur Orhangazi for excellent research assistance; to Bob Pollin for helpful comments; and to Rob Parenteau for help with data and financial accounting puzzles.

Review of Radical Political Economics, Volume 35, No. 3, Summer 2003, 271-279
DOI: 10.1177/0486613403255533
© 2003 Union for Radical Political Economics

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

major changes created by neoliberal globalization: (1) a slowdown in the rate of global demand growth and an increasing intensity of competition in key product markets that caused a downturn in NFC profit rates (see Figure 1); and (2) a shift from "patient" committed finance to impatient financial markets that raised real interest rates, forced NFCs to pay an increasing share of their cash flow to financial agents, drastically changed managerial incentives, and helped shorten NFC planning horizons.

NFCs were eventually placed in a *neoliberal paradox:* intense product market competition made it impossible for most NFCs to achieve high earnings most of the time, but financial markets demanded that NFCs generate ever-increasing earnings and ever-increasing payout ratios to financial agents or face falling stock prices and the threat of hostile takeover.

In several recent papers, I used insights from Schumpeter, Keynes, and Marx to explain why key nonfinancial product markets in the neoliberal era have been characterized by low profit rates, high leverage, and chronic excess capacity (Crotty 2000a, 2000b, 2002b, forthcoming). This article deals with the impact of changes in the relation between NFCs and financial markets over this period. (A complete exposition of these issues that includes a discussion of the "financialization" of NFCs can be found in Crotty 2002a.)

2. Effects of Changing Financial Markets on the Structure and Performance of Large Nonfinancial Corporations (NFCs) in the Era of Neoliberal Globalization

Influenced by the work of Chandler (1990) and Schumpeter ([1943] 1976), Lazonick and O'Sullivan (1996) argued that the most important function of the organizational structure of the successful Chandlerian firm is to foster process and product innovation over the long term. They believe that there are two necessary conditions for NFCs to achieve this goal: *organizational integration* and *financial commitment*. Organizational integration refers to the creation of a strong attachment to the long-run goals of the firm by its major stakeholders. Financial commitment is required because large-scale innovation is an uncertain, expensive, path-dependent, long-term process. Thus, only finance with a long-term commitment to the firm can provide the kind of money capital needed to sustain the innovation process. In the Golden Age, U.S. stockholders were indeed patient, allowing NFCs to retain and invest the lion's share of their abundant cash flow.

I stress two aspects of the changing relation between financial markets and large NFCs. The first is a shift in the beliefs and behavior of financial agents, from an implicit acceptance of the Chandlerian view of the large NFC as an integrated, coherent combination of illiquid real assets assembled to pursue long-term growth and innovation, to a "financial" conception in which the NFC is seen as a "portfolio" of liquid subunits that home-office management must continually restructure to maximize the stock price at every point in time. The second is a fundamental change in management's reward structure, from one that linked pay to the long-term success of the firm, to one that links it to short-term stock price movements. Both changes drastically shortened NFC planning horizons and led management to adopt strategies that worsened the overall performance of the U.S. economy.

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

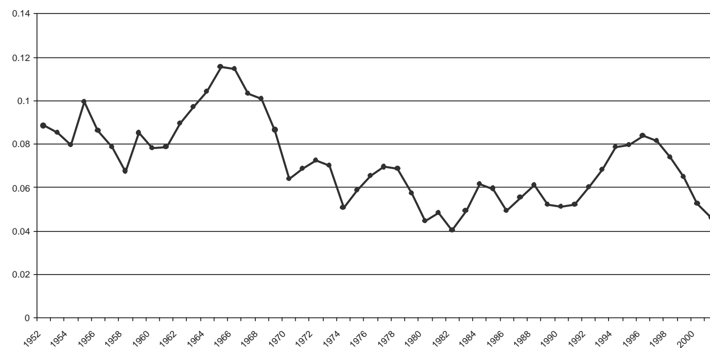

Figure 1.
Nonfinancial Corporation (NFC) Profits before Tax as a Percentage of Net Worth (with IVA [Inventory Valuation Adjustment] and CCA [Capital Consumption Adjustment]).
Source: Flow of Funds Tables F.102, B.102.

3. The Rise of the Financial or Portfolio Conception of the NFC in Financial Markets

The 1960s conglomerate merger movement initiated a change in the perception of the proper role of top management from one in which managers were expected to be experts in the main business of the firm to an evolving view of top executives as generalists who knew how to buy and sell subsidiaries as business conditions changed. This eroded organizational coherence by creating new conflicts of interest between home-office management and other stakeholders. This shift remained incomplete, however, until the hostile takeover movement of the 1980s, which forced NFC insiders to either divest units whose stock price fell below the level demanded by Wall Street or yield control of the firm to corporate raiders. Raiders relied primarily on debt to finance takeovers, while managers of targeted firms often defended their turf by loading the firm with debt-financed stock buybacks and special cash dividends to deter potential raiders. From 1984 through 1989 alone, 1 trillion dollars was borrowed to finance corporate takeovers or defend against them (Crotty and Goldstein 1993). These developments pushed NFC debt burdens to historic highs.

This shift in financial practice was supported by the development of "agency theory." Neoclassical financial economists applauded the hostile merger movement because they believed it reduced "principal-agent" or owner-manager conflict in three ways. First, it forced managers to disgorge cash flow both to creditors in the form of swollen interest payments and to shareholders through defensive stock buybacks and special dividends. Second, it made managers ruthlessly cut costs to generate the cash flow needed to meet the firm's crushing debt burden. (This led to slower aggregate demand, employment, and wage growth.) Third, the market for corporate control replaced managers who refused to maximize shareholder value as measured by the current stock price with others willing to do so.

It would be almost impossible to imagine a vision more at odds with the Schumpeterian and Chandlerian views of the firm than its financial conception in agency theory.

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

4. The "Shareholder Value" Movement: A New Alliance between NFC Managers and Financial Investors

Throughout the 1950s, households owned about 90 percent of corporate stock and tended to hold their stocks for long periods. By the late 1960s, institutional investors began to influence stock price movements. At the end of the 1970s, household stock ownership dropped to 59 percent. In 2000, households held 42 percent of public shares, while U.S. institutions owned 46 percent and were responsible for about three-quarters of all stock trades.

Intense competition between institutional investors to get and hold contracts to manage large portfolios led to constant asset "churning" in pursuit of short-term capital gains. Turnover on the New York Stock Exchange was about 20 percent from 1960 through the late 1970s. It increased to more than 70 percent in 1983 to 1987, the most hectic phase of the hostile takeover movement. After falling back toward 50 percent in the recession of the early 1990s, it exploded once again as the shareholder value movement of the 1990s moved into full swing. It exceeded 100 percent in the first half of 2002 (see Figure 2). On average, stocks are now held for just one year. Rational stockholders thus have no reason to concern themselves with the performance of the companies they "own" beyond a one-year horizon. Long-term considerations thus became largely irrelevant to stock price determination, just as rising stock prices over the short term became the dominant goal of the firm.

But pressure to keep stock prices rising also became internalized within NFC top management itself. Institutional investors tried to force management to meet their need for ever-higher stock prices through the spreading use of stock options, a pressure managers had no reason to resist. By the late 1990s, the dominant component of the pay of the management teams running America's largest NFCs was stock-price driven. The average proportion of the earnings of the top one hundred CEOs that came in the form of exercised stock options rose from 22 percent in 1979 to 50 percent in the late 1980s. In the financial boom years of 1995 through 1999, this average rose to 63 percent. Meanwhile, top CEO pay in all forms rose from $1.26 million in 1970 to $37.5 million in 1999 (Piketty and Saez 2001: Table B4). Gargantuan payments thus accrued to managers who could get their company's stock price above a trigger level, even for one minute.

The trigger price in the typical options contract was the current stock price. In the great bull market of the early 1980s through the 1990s, almost every listed firm saw its stock price rise, so large management pay increases became almost universal. From 1982 through 1999, the S&P 500 stock price index divided by the CPI increased at an average annual rate in excess of 12 percent, a cumulative rise of almost 700 percent. In the late 1990s bubble, the investing classes came to believe that annual gains on stock portfolios in excess of 20 percent would go on forever. Institutional investors demanded that NFCs produce rapid earnings growth so they could satisfy their clients, while top NFC managers needed to generate rapidly rising stock prices or their stock options would be worthless.

Thus, by the late 1990s, the rational pursuit of self interest by top managers led them to do whatever it took to keep stock prices rising even in the shortest of runs, an objective that required ever-rising reported earnings.

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

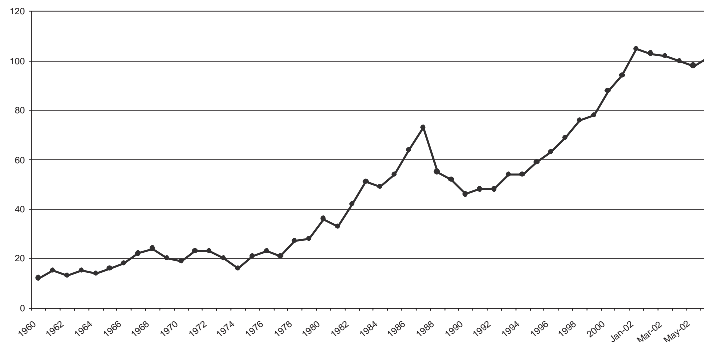

Figure 2.
Annual Stock Turnover Rate: New York Stock Exchange.
Source: New York Stock Exchange 2001 Fact Book and www.nyse.com.

5. The Logic of Financial Market Evolution: The U.S. Stock Market Collapse and the Crisis of Confidence in the U.S. Financial System

From its peak in July 2000 to early October 2002, the S&P 500 stock price index fell by more than 45 percent, while the Nasdaq index fell by about 75 percent. This stock market meltdown was accompanied by the worst U.S. financial scandal since the 1920s.

To understand how these events could have taken place in the richest country in the world, one that was believed to possess the deepest, most efficient, most transparent, and most "efficiently" regulated financial markets, one must understand the neoliberal paradox. Destructive competition in product markets in the past quarter century severely constrained the ability of NFCs to earn high profits and cash flow, yet financial markets demand ever-rising earnings to support ever-rising stock prices.

A precarious and unsustainable combination of forces led to a substantial rise in the NFC profit rate in the mid-1990s, but it peaked in 1996 and fell rapidly in 1998 through 2000. Yet financial market pressures and new NFC management incentives required that reported earnings rise virtually every quarter to prevent P/E ratios and stock prices from falling. Many of the largest NFCs reporting the fastest growing earnings, such as Enron and WorldCom, were what the business press calls "serial acquirers." By adding more and more businesses, these NFCs in effect bought the new earnings they could not gain through expansion in traditional product markets because of destructive competition. In the end, when even this strategy was not enough to keep earnings on the rise, management simply cooked the books. The neoliberal paradox helps us understand why, given conditions in product markets, nothing but massive fraud could have kept stock prices from falling after 1997.

Few people were aware of the extent to which these reporting distortions had grown by the decade's end. Yet evidence of massive fraud was freely available. Government NIPA (National Income and Product Accounts) data showed that profits as a percentage of value added in NFCs peaked in mid-1997 and fell by more than 20 percent in the next two years

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

(Council of Economic Advisers 2002b: 339). Even the nominal value of NFC profits peaked in 1997; it fell by 10 percent and 16 percent from its 1997 level in 1999 and 2000 respectively (Council of Economic Advisers 2002a: 8). Nevertheless, profits reported by S&P 500 corporations rose by 42 percent from 1997 to 2000. Financial asset prices in the late 1990s were driven by fraudulent information interpreted irrationally in a kind of mirror image of a neoclassical "efficient" financial markets model.

Severe conflicts of interest deeply embedded in the financial system allowed widespread fraud to take place. NFC managers with huge stock options were aided in their efforts to deceive investors by giant accounting firms that signed off on misleading financial statements because consulting contracts with these firms earned them more than auditing. Bank stock analysts issued only "buy" recommendations even when they knew better because their firms needed the investment banking and loan business of the same NFCs they were evaluating. Congress defeated all proposals to force firms to provide accurate income and balance sheet information because the financial and accounting industries are among the largest campaign contributors to Washington politicians in an era when elections are obscenely expensive.

6. Financial Agents Have Extracted an Increasing Share of NFC Cash Flow: Empirical Evidence from the Fed's Flow of Funds

These changes in product and financial markets and in the incentives guiding management led to a qualitative jump in the percent of NFC cash flow taken by financial agents. Figure 3 shows NFC net interest payments as a percentage of cash flow. The interest burden rose to 15 percent by the end of the 1960s, as debt increased and real interest rates increased. It stayed constant until the early 1980s, at which point superhigh real interest rates brought on by Paul Volcker's temporary conversion to monetarism followed by the debt-generating hostile takeover movement caused it to rise by decade's end to a postwar high of 30 percent. It then fell back toward 1970s levels in the mid- to late 1990s as real interest rates declined, interest *received* increased, and cash flow rose.

Figure 4 shows that the proportion of NFC cash flow extracted by financial markets in the form of dividends actually declined after the 1950s and 1960s. However, the rise of the shareholder value movement caused the dividend payout burden to double from the mid-1980s to the late 1990s, severely draining NFC funds.

Figure 5 shows net NFC stock *purchases* as a percentage of cash flow. Until the 1980s, NFCs were net sellers of equity, though they never raised large sums in the equity market. In the hostile takeover movement of the 1980s, NFC management bought its own stock to keep the raiders from the door, while a wave of mergers removed stock from the hands of the public. From 1984 through 1989, stock purchases ate up more than 20 percent of cash flow. Net purchases dropped off in the early 1990s but rose again after 1993 as the shareholder value movement gained strength. Stock buybacks had to be large enough to maintain upward pressure on stock prices in the face of large sales from exercised options. From 1995 through 2001, NFCs purchased $870 billion of their own stock, helping prolong the bubble. In 1998, buybacks cost more than 30 percent of cash flow.

Figure 6 shows total NFC payments to financial markets as a percentage of cash flow. It thus brings together product and financial market pressures impinging on NFCs. Destruc-

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

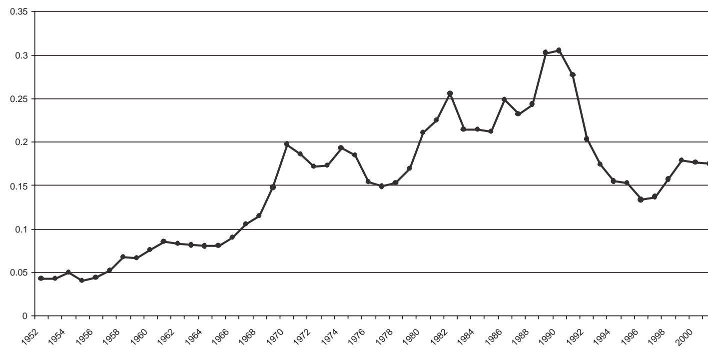

Figure 3.
Nonfinancial Corporation (NFC) Interest Payments as a Percentage of Cash Flow.
Source: Flow of Funds Table F.102; NIPA Table 1.16.

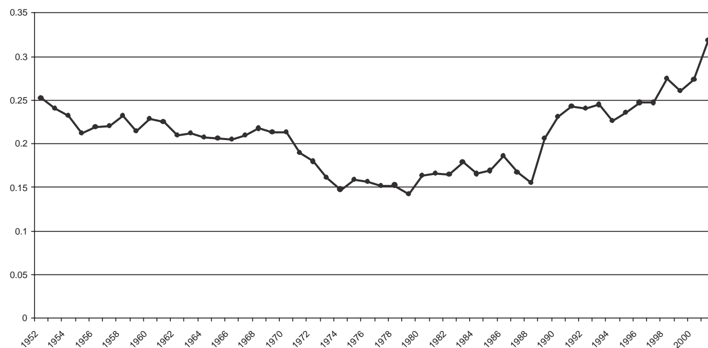

Figure 4.
Nonfinancial Corporation (NFC) Dividends as a Percentage of Cash Flow.
Source: Flow of Funds Table F.102.

tive competition constrained NFC cash flow, while financial markets forced NFCs to disgorge a growing share of their shrinking cash flow to financial agents. Financial market payments rose from relatively low levels in the 1950s to about 30 percent of cash flow from the mid-1960s through the late 1970s. But from 1984 through 2000, with the exception of three recession years in the early 1990s, NFCs paid out well over half their cash flow to financial agents. From 1984 through 1990 and again from 1997 through 2001, this ratio never fell below 50 percent. It peaked at 76 percent in 1989 and again at 74 percent in 1998.

Thus, the lion's share of NFC finance is now provided on the shortest of terms. NFCs must disgorge more than half of the cash flow they need to sustain investment and innovation over the long term, then compete with all other agents, foreign and domestic, to get it back. This is impatient capital in its most extreme form. It forces NFCs to either cut invest-

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

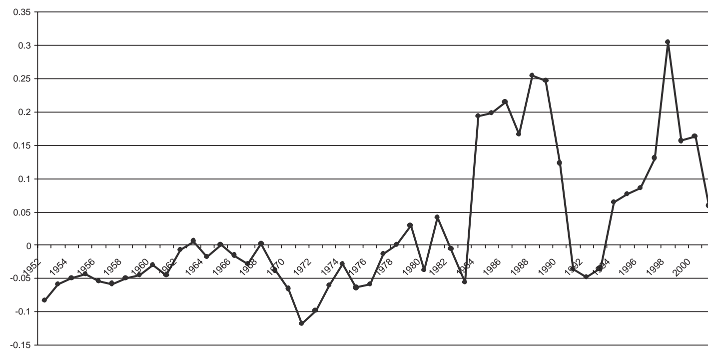

Figure 5.
Nonfinancial Corporation (NFC) Stock Buybacks as a Percentage of Cash Flow.
Source: Flow of Funds Tables F.102, F.213.

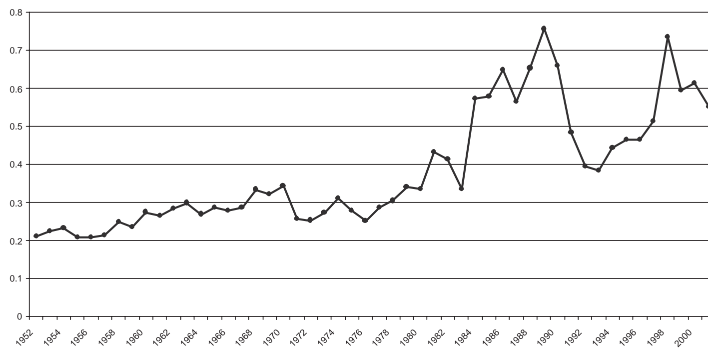

Figure 6.
Total Payments to Financial Markets by Nonfinancial Corporations (NFCs) as a Percentage of Cash Flow
Source: Flow of Funds Tables F.102, F.213; NIPA Table 1.16.

ment and innovation or face rising indebtedness. And it sustains cost-cutting pressure and "low-road" labor relations, which retard wage and employment growth.

7. Conclusion

Neoliberal globalization is destroying conditions in both product and financial markets that are necessary for the successful long-term performance of large nonfinancial firms and the economies that depend on them. It will not be possible for NFCs to lead either advanced or developing nations to long-term prosperity unless the neoliberal project is abandoned.

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010

References

Chandler, A. 1990. *Scale and scope: The dynamics of industrial capitalism*. Cambridge, MA: Harvard University Press.

Council of Economic Advisers. 2002a. *Economic indictors*. Washington, DC: Government Printing Office.

———. 2002b. *Economic report of the president*. Washington, DC: Government Printing Office.

Crotty, J. 2000a. *Slow growth, destructive competition, and low road labor relations: A Keynes-Marx- Schumpeter analysis of neoliberal globalization*. Available from http://www.umass.edu/peri/research.html #gm

———. 2000b. Structural contradictions of the global neoliberal regime. *Review of Radical Political Economics* 32 (3): 361–8.

———. 2002a. *The effects of increased product market competition and changes in financial markets on the performance of nonfinancial corporations in the neoliberal era*. Available from http://www.umass.edu/peri/research.html#gm

———. 2002b. Why is there chronic excess capacity? *Challenge* 45 (6): 21–44.

———. Forthcoming. Core industries, coercive competition and the structural contradictions of global neoliberalism. In *The new competition for inward investment: Companies, institutions and territorial development*, ed. N. Phelps and P. Raines. Northampton, MA: Edward Elgar.

Crotty, J., and D. Goldstein. 1993. Do U.S. capital markets allocate capital efficiently? The case of corporate restructuring in the 1980s. In *Transforming the U.S. financial system: Equity and efficiency for the 21st century*, ed. G. Dymski, G. Epstein, and R. Pollin, 253–68. Armonk, NY: M.E. Sharpe.

Lazonick, W., and M. O'Sullivan. 1996. Organization, finance and international competition. *Industrial and Corporate Change* 5 (1): 1–49.

Piketty, T., and E. Saez. 2001. Income inequality in the United States: 1913-1998. NBER Working Paper 8467, Cambridge, MA: National Bureau of Economic Research.

Schumpeter, J. [1943] 1976. *Capitalism, socialism and democracy*. London: Allen & Unwin.

Downloaded from http://rrp.sagepub.com at Fondation Nationale on March 9, 2010