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FINANCIAL MANAGEMENT

The Price of Wall Street's Power

by Gautam Mukunda

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ARTWORK: HUBERT BLANZ, FOUR ELEVATORS, 060, 2006, BLACK-AND-WHITE BARYTA PRINT ON ALUMINUM, 80 X 199 CM

Boeing's launch of the 787 was marred by massive cost overruns and battery fires. Any product can have technical problems, but the striking thing about the 787's is that they stemmed from exactly the sort of decisions that Wall Street tells executives to make.

Before its 1997 merger with McDonnell Douglas, Boeing had an engineering-driven culture and a history of betting the company on daring investments in new aircraft. McDonnell Douglas, on the other hand, was risk-averse and focused on cost cutting and financial performance, and its culture came to dominate the merged company. So, over the objections of career-long Boeing engineers, the 787 was developed with an unprecedented level of outsourcing, in part, the engineers believed, to maximize Boeing's return on net assets (RONA). Outsourcing removed assets from Boeing's balance sheet but also made the 787's supply chain so complex that the company couldn't maintain the high quality an airliner requires. Just as the engineers had predicted, the result was huge delays and runaway costs.

Boeing's decision to minimize its assets was made with Wall Street in mind. RONA is used by financial analysts to judge managers and companies, and the fixation on this kind of metric has influenced the choices of many firms. In fact, research by the economists John Asker, Joan Farre-Mensa, and Alexander Ljungqvist shows that a desire to maximize short-term share price leads publicly held companies to invest only about half as much in assets as their privately held counterparts do. Pressure to reduce assets made Sara Lee, for example, shift from manufacturing clothing and food to brand management. Sara Lee's CEO explained, "Wall Street can wipe you out. They are the rule-setters…and they have decided to give premiums to companies that harbor the most profits for the least assets." In the pursuit of higher stock returns, many electronics companies have, like Boeing and Sara Lee, outsourced their manufacturing, even though tightly integrating R&D and manufacturing is crucial to innovation.

In another article in this month's Spotlight package, Clayton Christensen argues that management's adoption of Wall Street's preferred metrics has hindered innovation. Scholars and executives alike have criticized Wall Street not only for promoting short-term thinking but for sacrificing the interests of employees and customers to benefit shareholders and for encouraging dishonesty from executives who feel they're being asked to meet impossible demands. The financial sector's influence on management has become so powerful that a recent survey of chief financial officers showed that 78% would "give up economic value" and 55% would cancel a project with a positive net present value—that is, willingly harm their companies—to meet Wall Street's targets and fulfill its desire for "smooth" earnings.

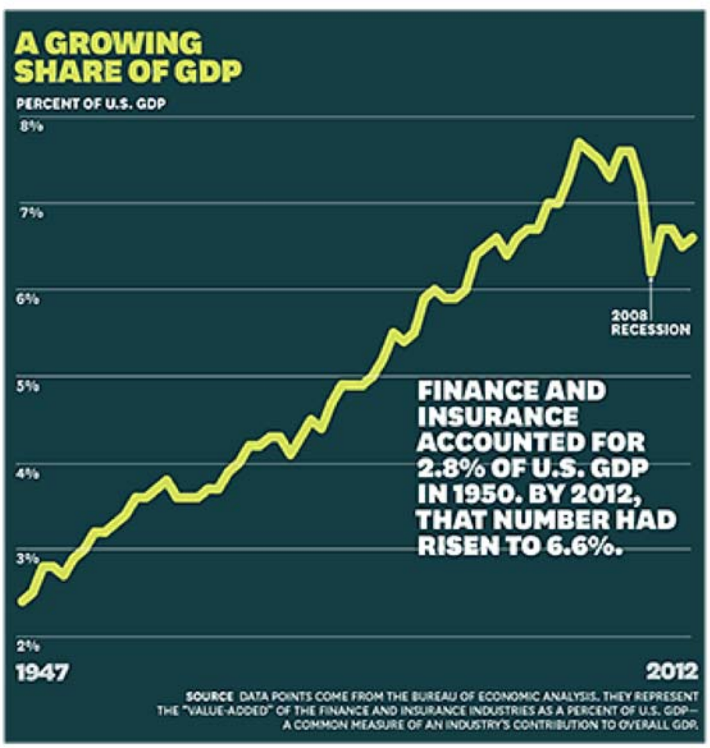
Executives often explain their deference to Wall Street by saying they have a "fiduciary duty" to maximize shareholder returns. That's been an article of faith since 1970, when Milton Friedman wrote in the *New York Times* that executives' only responsibility was maximizing profits. The problem, however, is that it's not true. Whatever your beliefs about the moral responsibilities of executives, a fiduciary duty is a specific legal obligation, and law professor Lynn Stout has shown that as a matter of law American executives simply do not face any such requirement.

So why do managers make choices they know are wrong? Why do so many believe (or act as if they believe) something that simply isn't right? I'm a political scientist. That means that, just as an economist thinks about money or a soldier about armies, I think about power. There are lots of situations in which people—and countries—act against their own interests. One of the most important—and most dangerous—is when a single sector or group is so powerful that it dominates how an entire society thinks about itself. Once you view research from a variety of fields through that lens, it becomes clear that we must do something to curb the enormous and disproportionate power of Wall Street.

Finance’s Rise to Dominance

Before the Great Depression, financiers’ status and influence were so great that when Theodore Roosevelt filed the first major antitrust lawsuit against J.P. Morgan’s railroad, Morgan told him, “If we have done anything wrong, send your man [the attorney general] to my man, and they can fix it up.” After the stock market crash of 1929, however, the United States passed the Glass-Steagall Act and other legislation to rein in the financial sector and increase stability.

Over the past several decades, those laws were largely undone. The most obvious consequence has been the tremendous growth of the financial sector. In 1970 the finance and insurance industries accounted for 4.2% of U.S. GDP, up from 2.8% in 1950. By 2012 they represented 6.6%. The story with profits is similar: In 1970 the profits of the finance and insurance industries were equal to 24% of the profits of all other sectors combined. In 2013 that number had grown to 37%, despite the aftereffects of the financial crisis.



These figures actually understate finance’s true dominance, because many nonfinancial firms have important financial units. The assets of such units began to increase sharply in the early 1980s. By 2000 they were as large as or larger than nonfinancial corporations’ tangible assets. During the early 2000s, for example, Ford made more money by selling loans than by selling cars, while GE Capital generated approximately half of GE's total earnings. If you include nonfinancial corporations, in 1980 the total value of U.S. financial assets was five times the country's GDP. In 2007 it was 10 times the GDP.

The jump in size and profits has also increased finance's influence on government. From 1998 through 2013 the finance, insurance, and real estate industries spent almost $6 billion on lobbying; the only sector to spend more was health care. In the wake of the 2008 crisis, the financial sector actually intensified its pressure on the government. Look at the 2013-2014 election cycle: As of March 2014 finance, insurance, and real estate had spent almost $485 million on lobbying—more than any other industry—and had donated almost $149 million to the campaigns of federal candidates, nearly three times as much as health care had donated.

Representatives and lobbyists of the financial sector are so entwined with the agencies that are supposed to regulate it that Washingtonians collectively refer to them as " The Blob." This is reflected in the résumés of current and former government officials. The most important financial regulator is the Treasury secretary. Let's look at the past six people who have held that office. Jack Lew, the current secretary, was previously at Citigroup. His predecessor, Timothy Geithner, is now the president of Warburg Pincus, a Wall Street private equity firm. Geithner's predecessor, Hank Paulson, was formerly the CEO of Goldman Sachs. Before him was John Snow, who is now chairman of Cerberus, a private equity firm. Snow's predecessor, Larry Summers, received more than $5 million from the hedge fund D.E. Shaw after leaving the Treasury, and his predecessor, Robert Rubin, also used to lead Goldman and took a senior position at Citigroup after leaving the government.

My research shows that leaders' paths to power crucially shape their actions in office. People who have spent their careers immersed in the financial sector are highly likely to share its worldview. Every one of those six men either had a substantial career in finance before joining the government or was sympathetic enough to the interests of the sector while in office that he had no difficulty finding a very senior, well-paid position in it once he left the job (or both). The issue, as former Federal Deposit Insurance Corporation chairwoman Sheila Bair explained, is "cognitive capture. It's not so much about corruption. It's just about listening too much to large financial institutions and the people who represent them and not enough to the people out on Main Street."

What Do I Mean by "Wall Street"?

The financial sector is diverse, and its different players have varying, and sometimes conflicting, interests. A savings and loan may seem to have nothing in common with a venture capital fund, and in many ways that's true. Yet all these players are both causes and beneficiaries of financialization. When I talk about Wall Street, however, I mean large universal and investment banks. This article, and the reforms it suggests, are primarily about them, and only secondarily about other parts of the sector, like private equity funds and large asset managers.

Wall Street's influence on policy is extraordinary, even after the financial crisis. To pick just three examples:

- Wall Street worked to slow the enactment of the Volcker rule, which was meant to prevent banks from using federally insured deposits to trade in their own behalf. In the months before regulatory agencies issued a draft of the rule, the financial industry representatives who were lobbying to weaken it accounted for 93% of the meetings the agencies involved had with outside parties.

- When the Commodity Futures Trading Commission (CFTC) attempted to regulate derivatives—financial instruments that played a key role in the crisis—Wall Street's response was a lobbying blitzkrieg. The result was a series of exemptions that ensured that the CFTC's regulations would cover less than 20% of the world market.

- Providing a stark signal that size has given Wall Street banks great strength, Attorney General Eric Holder testified before Congress that he had not prosecuted some banks because they were so large that charging them could hurt the economy. In other words, these banks are so powerful that the government's chief law enforcement officer has declared them above the law.

The finance industry's prestige has also rebounded to its 1920s apex. After the New Deal, Wall Street was viewed as a backwater. In 1949 Peter Drucker wrote that while "twenty years ago the bright graduate of the Harvard Business School aimed at a job with a New York Stock Exchange house, he now seeks employment with a steel, oil, or automobile company." In 2012, in contrast, the 10 most sought-after employers in the world included J.P. Morgan and Goldman Sachs. Thirty-five percent of the graduating Harvard Business School class went into financial services that year. That was actually a decrease from the peak, in 2008, when 45% did, but financial services remains the most common career path for HBS graduates.

Financialization: What It Is and What It Means

Financialization is the increase in the influence of financial markets, institutions, and elites over both the economy and the other institutions of society, including the government. The United States is far from the only country to have undergone financialization. The sociologist Giovanni Arrighi and others have identified a variety of historical examples, including Spain in the 14th century, the Netherlands in the late 18th century, and Britain in the late 19th and early 20th centuries. Strikingly, during their eras of financialization, the Dutch and the British observed and debated the transformation of their economy. Their financial elites, bolstered by increased fortunes, persuaded both countries to bet their future on finance. For example, in 1925 the British government chose to pursue a strong pound policy, which benefited Britain's financial services industry, instead of a weaker one, which might have spurred British manufacturing.

In a financialized economy, the financial tail is wagging the economic dog. An IMF study found, for example, that while a strong financial system is crucial to a country's early and intermediate-stage growth, once the sector becomes too large—when private-sector credit reaches 80% to 100% of GDP — it actually inhibits growth and increases volatility. In the United States in 2012, private-sector credit was 183.8% of GDP. Apart from its effects on firms like Boeing, there are two major ways in which financialization undermines economies. First, larger and more-complex financial systems may be more prone to crashes—a point made by a variety of economists, including Hyman Minsky, Charles Kindleberger, and Raghuram Rajan (who in 2005 famously argued that the risks of financial instability were much higher than most economists thought—only to be dismissed by Larry Summers as a "Luddite" for his skepticism of financial innovation).

Second, an overdeveloped financial system may misallocate resources. As far back as 1984 the Nobel Prize-winning economist James Tobin observed that "very little of the work done by the securities industry…has to do with the financing of real investment." He was troubled that "we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services…that generate high private rewards disproportionate to their social productivity."

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Some of this is about capital. Studies by Özgür Orhangazi, an economist, show that as financialization increases, investment in financial assets tends to crowd out investment in real assets, because the markets prefer short-term and liquid assets, and nonfinancial corporations face increased pressure to make investor payouts (principally through dividends or stock buybacks) instead of buying real assets.

Resource misallocation, however, stretches beyond capital, as Tobin observed. It's also about people. The British economist Roger Bootle argues that all economic activity can be classified as either "creative" or "distributive." Creative work increases a society's wealth. Distributive work just moves wealth from one hand to another. Every industry contains both. But activity in the financial sector is primarily distributive.

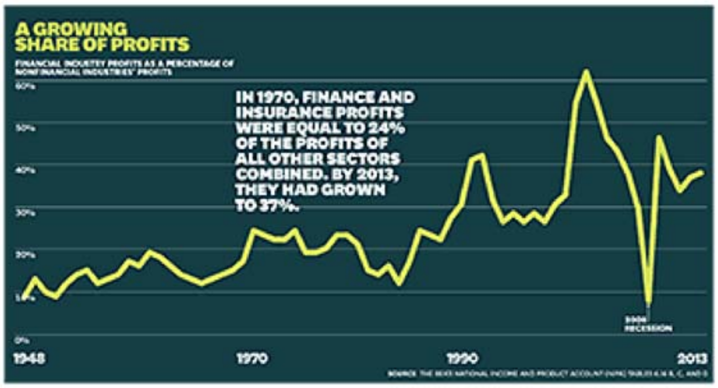
The financial services industry also has a very high level of a form of distributive activity called "rent seeking," which involves trying to make a profit by manipulating government policy. The economists Kevin Murphy, Andrei Shleifer, and Robert Vishny have shown that as a nation's most productive workers shift from entrepreneurial to rent-seeking activities, economic growth slows.

Wall Street is drawing America's best and brightest, and too many of them end up distributing wealth instead of creating it. Every brilliant computer scientist or engineer working to shave a nanosecond off the time it takes to complete a high-frequency trade isn't working at (or founding the next) Google, Amgen, or Tesla.

Another way to think about this is at the transaction level. In some industries, most transactions are positive sum. When you buy a car from Ford, ideally a year later both you and Ford are better off. You would rather have the car than the money, and Ford would rather have the money than the car. If I sell you a share of stock, though, a year later only one of us is likely to be happy. If the stock price went down, I am, and if it went up, you are (assuming you kept your share).

Most of the financial sector—retail and commercial banking, for example, or insurance and venture capital—engages in positive-sum transactions. However, in many of the sector's segments that have grown fastest since deregulation—like investment banks— the transactions are primarily zero-sum.

Pay in the financial sector is another sign of the industry's extraordinary clout. The economists Thomas Philippon and Ariell Reshef found that before the Great Depression, workers in finance made substantially more than those in other sectors, even after adjusting for their higher level of education. After Glass-Steagall passed, in 1933, this premium rapidly shrank, and by 1980 it had disappeared. After deregulation, the trend rapidly reversed, and by 2006 the premium had returned to its pre-Depression level.



The premium was large for everyone working in finance. In 2006 employees in finance made 50% more, on average, than equally well-educated employees in other parts of the economy. For senior financial executives, however, it was gigantic. They earned 250% more money than their nonfinancial counterparts did. For senior executives on Wall Street, it was larger still: They made 300% more than their counterparts in the real economy. Depending on how you calculate it, the wage premium in the financial sector accounts for 15% to 25% of the overall increase in economic inequality in America since 1980.

The Consequences of Power

So we're looking at a sector that serves vital functions (no modern economy can exist without banks) but that, when it grows too large, tends to slow economic growth, increase inequality, and experience crashes that exact a huge toll on society. (The 2008 financial crisis cost the U.S. government more than $2 trillion in lost tax revenues and increased spending.) Despite those drawbacks, the sector exerts great influence over the rest of the economy, even though many managers know that its demands hurt their companies. So we return to the question that began this article. Why do societies (and people) act against their own interests?

The answer can be given in two words: unbalanced power.

Just as a black hole's gravity shifts the orbits of stars many light-years away, great power and prestige change the behaviors of everyone around them, both directly and indirectly. The direct way is through coercion and inducement: Do what I want, and you'll be rewarded; disobey me, and you'll be punished. Direct power shows up every time donations sway a politician's vote.

The indirect way is far less obvious but even more important. Real power comes not from forcing people to do what you want but from changing the way people think, so that they *want*to do what you want. Acton famously said, " Power tends to corrupt, and absolute power corrupts absolutely." We usually think of this as an observation about the effects of power on those who have it. But Acton was actually talking about power's effects on our judgments of the powerful. There's a natural tendency to believe that those with power are good and just and doing the right thing. Power and prestige can make the practices of those who have them seem far more benevolent than they really are.

The ability of a powerful group to reward those who agree with it and punish those who don't also distorts the marketplace of ideas. This isn't about corruption—beliefs naturally shift in accord with interests. As Upton Sinclair said, "It is difficult to get a man to understand something when his salary depends on not understanding it." The result can be an entire society twisted to serve the interests of its most powerful group, further increasing that group's power in a vicious cycle.

This can happen even when the stakes are extremely high. Here's a historical example: Before World War I, virtually every aspect of German society was dominated by the military and the industries supplying it. Jealous of Britain's colonies and the prestige stemming from the Royal Navy's preeminence, Germany's military establishment wanted to build a navy that had enough battleships to challenge Britain's, even though the two nations were relatively friendly. To that end the German navy subsidized the Navy League, an organization devoted to pressuring the government for higher naval budgets, and created a news bureau to influence the press. The navy also recruited many of Germany's most prominent academics (including Max Weber, perhaps the greatest sociologist and political economist of his era) to tour the country speaking on its behalf. The result was a vast increase in the naval budget, which further strengthened the navy's influence over German industry.

The results were catastrophic. Britain saw Germany's navy as an unacceptable threat and aligned with France and Russia. When World War I began, those expensive German battleships made no significant contribution, and the country's navy turned to submarines to weaken Britain, which drew the United States into the war, guaranteeing Germany's defeat. The imbalance in its power structure made Germany spend enormous resources on an asset that didn't just have no value—it had negative value, because it drove Britain and the United States into the arms of Germany's enemies.

> The problems of a system where risks are spread across society but gains are concentrated in the hands of a few are obvious.

In the United States, of course, it's not the military but the financial sector—particularly Wall Street—that has disproportionate power. A strong financial sector is crucial to the country. The financial system is the economy's circulatory system. Without it, capital cannot flow to where it's needed. The large banks that have driven finance's incredible growth are the heart of the financial system. A heart, however, can grow so big that it weakens the body it is meant to sustain and even becomes unable to perform its basic functions. The American economy is suffering from an enlarged heart.

Fixing the Problem

We need to bring the system back into balance. Because the financial sector's power and prestige are products of its extraordinary size and profitability, we need reforms that reduce those to healthy levels without inhibiting the sector's critical functions. The key is to choose reforms that counteract the distortions created by finance's power—reforms that are worthwhile for purely economic reasons. They will be fought because they reduce the profitability and power of some in the financial sector. But that's the point. Reforms that don't do that won't work.

The idea that economic policy should consider power is almost as old as the United States. It goes back to Washington's first cabinet and the rivalry between Jefferson and Hamilton. The two had different views of how the American economy should evolve, but those views were shaped as much by their beliefs about what would foster democracy as by what would generate wealth. In the 20th century, the antitrust thinking of Louis Brandeis—one of the key inspirations for Glass-Steagall—stemmed from his apprehensions about the influence and power that large financial firms could gain over both industry and government.

Here are a few potential approaches to this sort of reform:

Limit the size and leverage of banks.

The largest U.S. banks grew rapidly after financial deregulation and got even bigger after the crisis. In 1995 the assets of the six largest U.S. banks were equivalent to 17% of the country's GDP. By 2006 that number had grown to 55%. By 2013 it was 58%. Big banks extract an enormous indirect subsidy from the government. The market believes that their debts are implicitly guaranteed by the government, which lowers their borrowing costs. In 2012 this subsidy was worth as much as $70 billion—or 2.5% of total federal tax revenues—to the eight largest U.S. banks. If banks were kept small enough that the government might let one fail, it would minimize both their power and the subsidy. In *13 Bankers,* Simon Johnson and James Kwak propose that the assets of universal banks (which combine both commercial and investment banking) should never rise above 4% of GDP, and the ceiling for investment banks should be set at 2%. This would affect only a few companies, but those few wield immense power.

> Real power comes not from forcing people to do what you want but from changing the way people think, so that they want to do what you want.

A second way in which banks have grown their power is by increasing their leverage. This increases their profits but also raises their risk, because the more leveraged they are, the smaller the mistake it takes to wipe them out. This risk is shifted to the public when banks can count on a bailout. The problems of a system where risks are spread across society but gains are concentrated in a few hands are obvious, but banks' political power has prevented regulators from taking action. In *The Bankers' New Clothes,* the economists Anat Admati and Martin Hellwig show that if bank leverage were capped at 3:1—that is, if shareholder equity made up at least one-quarter of banks' total liabilities—it would have no effect on banks' ability to make loans while vastly improving the financial system's stability.

Put debt and equity on a level playing field.

Debt markets are far larger than equity markets, and debt creates risks that equity does not. The more indebted a company is, the more subject it is to the whims of financial markets. In his book *High Commitment, High Performance,* my colleague Mike Beer has described how CEOs dedicated to building great companies avoid debt for precisely this reason. The U.S. tax code, however, makes interest payments (but not dividends) tax-deductible, subsidizing debt at the expense of equity. Combine that tax preference with the very high U.S. corporate tax rate and companies have a strong incentive to borrow. Remove the subsidy for debt, and you decrease the power of the financial sector over the rest of the economy. My colleague Robert Pozen has suggested limiting such deductions while lowering the corporate tax rate.

Tax financial transactions.

Another source of both power and profits for the financial sector is the enormous volume of financial transactions in today's capital markets. However valuable these might be individually, in aggregate they impose significant costs on the rest of society (like slower growth and periodic bailouts) that are not borne by their participants. One way to deal with things that produce negative effects on society is to tax them.

Additionally, the low cost of trading shares encourages investors to view them as short-term financial instruments, not long-term investments. A tax on financial transactions—initially envisioned by Keynes in 1936 and applied to currencies in 1972 by Tobin—would reduce volatility, shift investors toward a longer-term focus, and weaken another source of financial sector power. Forty countries impose such a tax, and the United States had one from 1914 to 1966.

Treat investment income like ordinary income.

Another effective subsidy for many in the financial sector stems from the lower tax rate on capital gains. In theory this encourages investment and, therefore, economic growth. In practice the link does not hold up. Studies by the economist Leonard Burman and the nonpartisan Congressional Research Service show no relationship between U.S. economic growth and capital-gains tax rates. This differential in tax rates means that people whose income comes from investments keep substantially more of it than those who live off their labor. This significantly increases the after-tax income of many in finance (and of executives paid primarily through stock options—a compensation practice based on the mistaken belief that maximizing shareholder returns is an executive's only responsibility). That, of course, increases their power and prestige. Why should the government subsidize financiers and senior executives at the expense of scientists and soldiers when there's no economic benefit from doing so? A policy based on a plausible but flawed theory—which in practice favors an elite group—is a classic example of the distorted thinking caused by an imbalance of power.

For a generation the U.S. financial sector has grown hugely, vastly enriched its most powerful members, and been deferred to by the nation's businesses and government. At the same time, the financialization of America has obscured and even hindered the critical work done by most of those in the sector, ranging from retail and commercial bankers to venture capitalists to insurance adjusters.

Nonfinancial businesses need to make restoring balance a priority. Power can be countered only by power, and however strong Wall Street is, the businesses that make up the rest of the economy are far stronger. Believing that most markets are overregulated and that financial markets are underregulated—that deregulating airlines was a great idea but deregulating banks was a disastrous one—is perfectly consistent. Financial markets are different from other markets and so should be treated differently. An American business community mobilized by the knowledge that financialization was a drag on its success would be a force to be reckoned with.

> Major banks used their ownership of storage facilities to drive up the price of aluminum, costing consumers $5 billion.

Nonfinancial businesses are already starting to push back. Last year the *New York Times* reported that major financial institutions had been using their ownership of aluminum storage warehouses (Goldman alone owned facilities that held 70% of North American aluminum inventory) to drive up the price of aluminum, which has cost U.S. consumers as much as $5 billion since 2010. Companies that use aluminum complained, resulting in a Senate hearing and a Federal Reserve review of a 2003 ruling allowing banks to trade physical commodities. As companies realize that this was only a specific example of a general problem, they should push for financial reform just as hard as they would for any other issue crucial to their competitiveness.

Leadership is every bit as important. In *Indispensable: When Leaders Really Matter,* I describe how, even though leaders are often constrained by circumstances, the right person, in the right place, at the right time can transform companies, militaries, and even entire nations. Abraham Lincoln reforged the United States in the fires of the Civil War. Franklin Roosevelt gave the American people a New Deal in the depths of the Great Depression. Leaders—especially presidents—can reshape the political debate and shift the entire country into a new and better political equilibrium. In the aftermath of the 2008 crisis, the financial system perhaps was too fragile to risk reforms like the ones described here. In 2013 it was doing well enough that the average Wall Street bonus was $164,530—the highest since 2007. We continue, however, to face chronic unemployment, slow economic growth, stagnant median incomes, and every other characteristic of a wounded economy that has limped on for so long that it threatens to become the new normal.

It doesn't have to be this way. Roosevelt's response to Morgan's offer to "fix it up" was clear: "That can't be done." His attorney general explained, "We don't want to fix it up. We want to stop it." Two years later, Roosevelt's administration broke up Morgan's trust. Morgan was vastly more powerful than any financier today. He may have controlled as much as 40% of all the capital in the United States. But that didn't stop Roosevelt from taking him on.

What we've been doing is not working. It wasn't working even before the crisis, when the real estate bubble concealed the economy's deeper problems. Today the economy's failure to deliver the jobs and incomes that Americans expect and deserve is plain for all to see. We can rebalance our society and liberate U.S. companies to do what they have always done so well—create wealth that benefits every American. We can do better. The choice is up to us.

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