real-world economics review, issue no. 68
subscribe for free

Financialization, income distribution, and social justice: recent German and American experience

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Although many economists and business writers have discussed increased financialization since the1970s, they have paid scant attention to the impact this change may have had on the distribution of incomes in Western economies. This paper compares and contrasts in this respect American financialization with German over the past half-century. According to Petra Dünhaupt, finanzialization in the two countries differed: "In the US, the important shift towards financialization occurred in the early 1980s, …in Germany the process of financialization started much later – in the beginning of the 1990s – and followed a much more gradual transition." (Dünhaupt, 2012, 1) The analysis is pursued historically, on the grounds that an understanding of the financialization of the German economy requires an investigation of intergenerational institutional legacies.

The financialization referred to here can be described as the transition from management capitalism to finance capitalism. More specifically, it is the change from viewing a business as a vehicle for earning "returns on investment . . . based on the value created by productive enterprise" to viewing a business "as assets to be bought and sold for maximizing profits through financial strategies." (Ball & Appelbaum, 2) Large-scale industrial organizations in which the internal "visible hand" of management orchestrated productive activities formerly coordinated through the external "invisible hand" of market transactions first emerged in the United States in the 19th century. By the 1920s, many of these organizations, as famously described by Alfred D. Chandler, Jr. in his path-breaking book *The Visible Hand* ,1977, (Locke & Spender, 2011) had evolved into complex multi-divisional enterprises that arguably represent the pinnacle of management capitalism's development. Indeed, large managed enterprises have flourished in the global economy from the early 20th century to today. But changes in financial markets, financial institutions, and management compensation after the 1960s increasingly shifted the attention of managers from producing and selling products and non-financial services to seeking returns from financial activities. These changes from management capitalism to finance capitalism had profound consequences for the distribution of incomes. However, the fairness of that distribution varied greatly from nation to nation, depending on their institutional and governance forms and how democratically members of each society could alter those forms. Here we particularly examine how institutional and governance differences shaped outcomes in Germany and the United States.

Financialization and executive compensation

Epstein defines "financialization" as the "increasing importance of financial markets, financial motives, and financial institutions, and financial elites in the operation of the economy and its

[1] I would like to thank H. Thomas Johnson for his critique of my original comments about financialization.

governing institutions, both at the national and international level" (Epstein 2005, 1). Dünhaupt posits five ways that financialization has affected the compensation of executives:

1. It shifted the basis of enterprise finance from banks to capital markets;
2. It reinvigorated the "rentier" class that had been on the decline by creating institutional investors (e.g., pension funds) that base investment decisions solely on stock prices and short-term return on investment;
3. It linked financial trading to new financial institutions (e.g., investment banks, hedge funds, and private equity firms) and new financial instruments (e.g., derivatives, stock options, and credit swaps);
4. It stressed profit-making through financial activities instead of through real productive activity;
5. Under the guise of increasing share-holder value in a firm, it subordinated the interests of stockholders as governing agents of nonfinancial firms to those of directors (and, implicitly, those of Wall Street analysts, investment bankers, and large investors). In effect, this made directors, not stockholders, the chief beneficiaries of financialization (Dünhaupt, 2011, 10; Locke, 2012; Ball & Appelbaum, 3).

The fifth point raises an interesting issue. The financialization of firm governance is often equated with stockholder primacy because decision-making still resides in the CEO and the board of directors. Thus, because the stockholders choose the CEO and board it suggests that they remain in charge. This, however, is not exactly what happened in large US firms. Through control of the proxy process, incumbent CEOs have come to nominate their own candidates for board memberships, thereby making the boards director-selected instead of shareholder-selected entities. According to Stephen Bainbridge "director primacy" has placed "power and the right to exercise decision- making neither in shareholders nor the managers, but in the Board of Directors," who have claimed the right to assure the "efficient maximization of shareholders' residual claims," without the shareholders in effect being able to control the board (Bainbridge, 2006, 1).

If CEOs have escaped stockholder control through their *de facto* power to appoint directors, the rise of the institutional fund managers gives even further power to the CEOs. The institutions that employ these managers, primarily public and private pension funds, by 2000 came to own almost fifty percent of the equity of American corporations. Approximately fifty percent of Americans either owned stock individually or, more typically, had an ownership or retirement interest in these fiduciary institutions. The institutional fund managers did not threaten director primacy or CEO control because they could step in and micromanage firms in which they held stock. Institutional fund managers have in fact honed few of the skill-sets necessary to replace errant corporate managers. These fund managers live in the investment world, operate by its rules, and have little knowledge about how actually to manage firms in which they place investments. Laurence Mitchell stressed this point in *The Speculation Economy* when he described how the institutional investment managers slavishly follow the Capital Asset Pricing Model (CAPM) in their investment calculations:

> "The product of a regression analysis called *beta*, CAPM allows investors to build the kinds of potentially lower-risk, higher-return portfolios ...described by [the Nobel Prize winning economist] Markowitz, based solely upon a narrow range of information about the stock. The business itself matters little, if at all. All an investor needs is *beta*. No balance sheet, no profit and loss statement, no cash flow information, no management analysis of its performance and

> plans, no sense of corporate direction, no knowledge of what is on its research and development pipeline, no need even to know what products the corporation makes or what services it provides. Just *beta*. The stock is virtually independent of the corporation that issued it. CAPM has been adopted and is daily used by countless stock analysts and institutional money managers. Almost every American who invests in the market through mutual funds or other institutional media has invested on the basis of CAPM" (Mitchell, 2008, 275).

Nonetheless, the rise of institutional investors has affected firm governance in two important ways. First, everybody knows that the incomes of the top one percent of Americans, in which category American CEOs belong, have increased dramatically in recent decades. If their percentage of wages is subtracted from labor's share of seventy-one percent in the late 1970s (the bottom ninety-nine percent of wages earners), the percentage of income of the bottom ninety-nine percent declines as of 2005 by ten percent, which means that only the incomes of the top one percent grew, and did so substantially, in those decades. (Dünhaupt, 10) That the incomes of the richest have benefitted handsomely is common knowledge, but the fact that the growing gap between the top one percent and the bottom ninety-nine percent can be attributed almost exclusively to the financialization of CEO salaries through stock options is perhaps not so well known. Dünhaupt claims as much -- that the introduction of stock options into American CEO pay is solely responsible for increasing their share of total incomes from two percent in 2000 to eight percent in 2007 (2011, 19). She concludes that given the proximity of CEOs' position to capital owners rather than to workers, the stock option is closer to capital income than to wage income and should be classified with the former, i.e., with financialization, rather than with earned wages. Her point has been reinforced during this era of financialization, since the view of labor that prevailed under managerial capitalism as a quasi-fixed asset or human capital changes under financialization to one of "labor being considered a variable cost to be minimized" (Ball & Appelbaum, 6).

Financialization of director salaries encourages those at the top, in their own interest, to adopt a short-term Wall Street focus when running their companies. Mitchell reports that almost eighty percent of more than four hundred chief financial officers in major American corporations recently surveyed, would have at least moderately mutilated their businesses in order to meet analysts' quarterly profit estimates. Cutting the budgets for research and development, advertising and maintenance and delaying hiring and new projects are some of the long-term harms they would readily inflict on their corporations to achieve good short-term numbers. The same influence of financialization holds when CEOs cut costs by downward pressure on employee wages and the elimination of a firm's legacy costs (pensions and benefits), policies that have been relentlessly pursued during and since the last two decades of the 20th century (Locke & Spender, 2011, 153-56). These cost-cutting measures fit the financialization view that labor is not a firm asset (human capital) but a variable cost to be minimized. Cutting labor costs has a favorable impact on the market, driving up a firm's stock price and with it the firm directors' incomes.

The second way financialization affects director primacy governance is much more constraining for top executives. If not haunted with fears that institutional investors will take over daily management of their firms, firm directors do fear that institutional investors might divest their holdings of a firm's stock if the firm's profits and stock valuations fall. As Mitchell put it:

> "Failure to meet quarterly numbers almost always guarantees a punishing hit to the corporation's stock price. The stock price drop might cut executive compensation based on stock options, attract lawsuits, bring out angry institutional investors … and threaten executive job security, if it happened often enough. Indeed, the 2006 turnover rate of 118 percent on the New York Stock Exchange alone justifies their fears" (Mitchell, 2008, 1).

A final point, financialization also invaded US capitalism in more profound and institutional ways – through the spawning of venture capitalist firms, angel investor networks and IPOs, through the promotion of private equity buyouts, amalgamations, and other schemes of privatization that whet the appetites of the investor class and fill the wallets of their agents with lucrative commissions for dealmakers in hedge funds, private equity firms, and investment banks.

The intensity of the reaction to Thomas Piketty's claim in his blockbuster book *Capital in the Twenty-First Century* ("If the rate of return on wealth ® is greater than the rate of growth, then wealth is likely to be ever more concentrated") is explained by financialization. Most of the debate seems to be about what Piketty means by Capital i.e., that he was emphasizing financial not physical capital. Merijn Knibbe in his 1 May 2014 post on the Real-World Economic Blog" explains **"**When we want to analyze economic growth, we might want to use an index of the amount of physical capital. When we want to study inequality, it might be wiser to look at the liability side of the balance sheet (finance capital)." People study the financialization process because it has contributed so much to inequality. It is handled as an example of convergence theory: what began in America and the UK spread, especially after the fall of communism in 1990 to the rest of the world using the financial theories and managerial tools of US-UK finance capitalism. But there is evidence that places outside their obit, with divergent business and banking traditions reacted, because of them, more successfully resisted financialization and the crisis it brought. One of the places is Germany (see David Ruccio's 5 May 2014 post in *rwer*, "12-country 1975–2007 chart of share of income growth going to the 1%" for distribution differences).

Germans adopted elements of American financialization later (stock options were not allowed in Germany until 1998), and German economic institutions exuded a methodological communitarian ideal in contrast to US methodological individualism and materialism that fostered financialization processes (stock option remuneration, IPOs, private equity firm takeovers, director primacy governance, etc.) that drove a wider gap between top and bottom US incomes than German. The German institutions discussed are in the banking and educational systems.

Banking systems

When the Berlin Wall came down in 1989, European banking everywhere rested on three pillars: private commercial banks, public saving banks, and co-operative banks. Traditionally the big German private banks had operated in the "kingly merchant tradition," where a firm retained a *Hausbank* and relations with it rested on trust, i.e., customers were not customers in the American sense but clients (Batiz-Lazo, Locke, & Műller, 2008). The new information technologies churning out of America allowed the flow of monies to increase dramatically and permitted investors everywhere to trade in rapidly created equity markets twenty-four hours a

day. Taking advantage of this technology and the expanding geographical opportunities accompanying the collapse of communism, American and UK financial houses rooted in equity markets began to promote the financialization of enterprise in Europe by facilitating mergers and acquisitions, debt management, and capital acquisition.

This British and American *Drang nach Osten* [push to the East] affected the investment business of major German private commercial banks in their own country; by 2004 they only transacted 38.3% of the German merger and acquisition business, 21.8% of the German equity market business, and 16.3% of the debt market business (*The Economist* 1.11. 2004, 82). J.P Morgan, Morgan Stanley and Goldman Sachs beat the German banks in their own backyard because it was an American kind of capitalism. According to *The Economist* (27.03.2004, 75) the position of German banks became so bad that a German agency, the Kreditanstalt fűr Wiederaufbau, thought it best in order to optimize results in the privatization of Deutsche Telekom to auction off large blocks of the company's shares through foreign investment banks, rather than through the investment bank arms of Deutsche Bank, Dresdner Bank and other German banks.

German private commercial banks decided that survival depended on the adoption of the new model. They moved onto the turf of American and British capitalism, began trading in securities and engaging in business consultancy. They also, following the UK and US banks, marketed new products and services. These included selling loan packages, credit cards, insurance, and organizing electronic banking through automated machines, and on-line services. Banks acted less as *Hausbanken* for large companies and held less of their clients stock in their portfolios (Lütz, 2000). They shifted from the kingly merchant tradition environment of trust in retail banking to one of persuasion, to letting impersonal market mechanisms set price and determine transactions.

In 1990, the business model of the second pillar, the European public savings banks, had five features. First they were "public," which meant they were "in a certain sense owned or sponsored and governed by some regional or local public body such as a city or a county or region." Second, they were organized under a public law regime. Third, they had "a dual objective: They were expected to support the local economy and the local people, and at the same time to operate according to common business rules and thus to be financially sustainable enterprises." Fourth, they had to adhere to the "so-called regional principle, which restricts the operations of a saving bank to the area for which the public body is responsible." As they were firmly rooted in the local economy, they did not compete with each other; "savings banks in a county or region had reason to consider each other more as peers and colleagues than as competitors." Fifth, they "were part of dense and closely cooperating networks of legally independent institutions that constituted a special banking group." Germans use the term "Verbünde for these dense networks, a term, Bübül, Schmidt, and Schüwer point out, that is hard to translate into English, "since such networks of banks do not exist in Anglo-Saxon countries" (3).

Cooperative banks, the third pillar, were also banks that adhered to the regional principle and were part of dense networks. Their "mandate was to support economic undertakings of their clients and to be cost-covering and profitable businesses. Cooperative banks were organized almost like clubs wherein the owners and providers of equity were not called shareholders but members. The difference between shareholders and cooperative bank members is that the latter could not "sell their shares if they wanted to exit, at some market price, but only hand

them back to the cooperative and in return get back what they had originally paid for them plus their part of the cooperatives accumulated profits." Accordingly, they could not "benefit from policies that would increase the value of their shares because they could not sell their shares at higher prices" (Bübül et al, 3).

In the 1980s British and American banks and their European partners pushed, as they did in the first pillar, the private commercial banks, to "modernize" the other two. "Strongly opposed to publicly owned banks" EU banking bureaucrats, who were educated in US financialization, joined in, since they thought public savings and cooperative banks old fashioned and outdated, because they did not conform to the "model" of how a good modern bank should be structured and operated.

Reform occurred in Belgium, where savings and cooperative banks essentially disappeared, in the UK where public savings banks (TSB) were sold to Lloyds Banking Group, and several cooperative banks, the so-called building societies, sold to large private banks; in the Netherlands savings banks disappeared and independent cooperative banks were amalgamated into one big national bank (Rabobank); in Sweden the former local savings banks were converted into joint stock corporations in the 1990s and most consolidated into a single national savings bank (Swedbank); in Spain local savings banks, the *cajas*, were privatized and localization abolished. They were permitted to provide a broad range of financial services in all parts of the country, becoming universal banks, which invested heavily in real estate loans, with the approval of pre-financial crisis reformers who believed that regional banks could not compete with other banks operating with large branch networks.
Only in Germany did the other two pillars of banking (423 savings banks and 1,116 cooperative banks) remain a "special case in which no substantial changes [occurred] during the last decades" (Bübül et al, 3). The savings banks have remained local and public and cooperative banks have not become essentially profit oriented institutions seeking to enhance shareholder value; nor has either been turned into centrally located stock-exchange listed corporations. Since each sector had a system of joint and several liability even before the financial crisis began, no individual member bank was allowed when it came to go bust. They came through the crisis with barely a scratch and, their spokesmen argue, their business model, working for the public or mutual good rather than for shareholders, has proved to be well-suited to the mixture of households and small companies (known as the *Mittelstand*) that they serve **(**Gerada & Netessine,1).

This statement is borne out by their lending record since 2007. Private German commercial banks reduced their medium- and long-term lending to companies and households between 2007 and 2012 in favor of short-term loans, while the German savings and cooperative banks did the reverse. The savings banks and cooperative banks currently provide about two-thirds of all lending to *Mittelstand* companies and 43% of lending to all companies and households.

Most people now agree that "the amazing resilience of the German economy" can be attributed to its reliance on the small to medium size enterprises of *Mittelstand* companies: Seventy percent of Germans are employed by them in the private sector. Inasmuch as private and cooperative banks have financed these flourishing *Mittelstand* firms, judgments about these two pillars of German banking have changed from those of the pre-financial crisis era. Petra Dünhaupt notes that locally rooted banks "compared to private commercial banks," performed well before and after the crises, (18) and that the modern view that "capital markets, in which banks are large, private, purely shareholder-oriented and exchange-listed corporations has been severely discredited by experience from the recent financial crisis."

(19). The best business model, she writes, is "being firmly rooted in the local economy and aspiring to strike a balance between the need to make a profit and the aim of serving members and clients, and the appropriate institutional structure is being embedded in a decentralized and dense network of affiliated financial and non-financial institutions" (19).

My own experience illustrates how the second pillar of the banking system worked locally during the financial crisis. In 2004 I bought a ruined house in Görlitz, Germany, the price of which was set by an engineer in a city-affiliated organization, not the market. The purchase agreement stipulated that the new owner had to renovate the building within five years or it could be reclaimed from them by the city at original cost. The construction office in City Hall stipulated that I had to apply to them for the construction permit, and choose the construction foreman from a list of experienced people approved by it. Needing funds, I asked the local branch of Deutsche Bank for 100,000 Euro to help carry out renovations. They rejected the request out of hand; when asked why, they replied, quite arrogantly, that they did not provide explanations. The construction foreman on his own contacted the local savings bank (Sparkasse) and carried out the negotiations with my approval; the bank authorized a 20-year loan at a very low fixed-interest rate. But with stipulations: I had to deposit $100,000 my Sparkasse account, and pay it out fully on renovation before the authorized Sparkasse renovation loan money could be touched. The bank officers supervised the process. My $100,000 spent on renovation, the Sparkasse released their renovation money in three installments, paid after their officers verified that the work at each stage had been completed.

The construction foremen noted that the Historic Buildings Preservation Authority (*Denkmalschutzamt*), headquartered in Dresden with a branch in Görlitz, subsidized the restoration of historic buildings' exterior shells; he did the paperwork, the agency approved (thirty percent of costs estimated at 100,000 Euro). The subsidy came from three sources: the city, state (Saxony) and federal budgets – a good example of dense networking.

The city finance office also permitted the VAT paid on renovation labor and materials, starting in 2004, to be deducted from the turn-over tax because I had declared my intent from the beginning to open a bed and breakfast on the site, even though the B&B was not actually opened until 2008. But The Finance Office, to stop speculation, specified that if I sold the property within ten years (dated from 2008), I would have to pay back all the subsidies and tax concessions I had received and pay a very hefty capital gains tax if the selling price warranted it (unless the new owner took over the B&B and ran it). I had to be good citizen, not a foreign speculator. None of these transactions had to do with interest rates set by capital markets, with financialization, or with returns to stockholders in a privatized bank. They did have to do with policies followed by public savings banks and regional nonfinancial agencies that supported local enterprise and city improvement**.**

Discussions about the distribution of incomes in America and Germany should, therefore, depend as much on how they are embedded in the social and institutional financial-banking systems of each country as on income amounts or the extent of the gap between the top one and bottom ninety-nine percent. Two examples can be used to illustrate this point. One concerns the group composition of the top twenty firms in each country, ranked by revenues (2012).

USA

1. Exxon	11. AT&T
2. Wal-Mart	12. Valero Energy
3. Chevron	13. Bank of America Corp
4. Conoco-Philips	14. McKesson
5. General Motors	15. Verizon Communications
6. General Electric	16. JP Morgan Chase & Co
7. Berkshire-Hathaway	17. Apple
8. Fannie Mae	18. CUS Caremark
9. Ford	19. IBM
10. Hewlett-Packard	20. Citi Group

(Source: C Stahl (2013) "Corporate Responsibility in US & German Firms," 59)

Germany

1. Volkswagen	11. Aldi Group
2. E. ON	12. BP Europa SE
3. Daimler	13. Robert Bosch
4. Siemens	14. RWE
5. BASF	15. Rewe Group
6. BMW	16. Edeka Group
7. Metro	17. Audi
8. Schwarz	18. Thyssen Krupp
9. Deutsche Telekom	19. Deutsche Bahn
10. Deutsche Post	20. Bayer

(Source: *Ibid*, 61)

Some firms on each list are classifiable under the same rubric, e.g., retail giants (in the US Wal-Mart and McKesson; in Germany the Aldi and Edeka Groups). Others are famous oil and energy firms, mostly on the US list. Whereas few of the firms on the US list were famous before WWII (Ford, GM, GE), such firms dominate the list of the German top twenty, many of them prominent even before the First World War (Deutsche Post, Robert Bosch, Daimler, BASF, Thyssen Krupp, Bayer, and Deutsch Bahn). From a financialization perspective, the big difference is that among the top twenty US firms there are many drivers of financialization (Berkshire-Hathaway, Fannie Mae, Bank of America, JP Morgan Chase Co, Citi-Group, and GE Financial), or US firms that are the creation of financialization (Hewlett-Packard, IPO 1957, Apple, IPO 1980). On the German list, there are none, i.e., not one is a financial institution, not one is a stock market creation, although many well-known German firms went public when the era of financialization began.

The second example is about firm governance and how it affects income distribution**.** Under director primacy US CEOs set their own salaries using financialization instruments liberally; in large German firms, in the system of co-determination, supervisory boards , which are fifty percent elected by firm employees (usually members of unions) and fifty percent by stockholders, set the salaries of management (the Vorstand). One might think the presence of employees' representatives on supervisory boards would push director salaries down, but this has not especially been the case. Apparently, in periods of prosperity, financialization of top salaries has occurred in large German joint stock corporations, because supervisory boards

have been generous in their granting of stock options, bonus provisions, and high salaries to their managing directors, to the point that *Vorstand* incomes in these big German firms have started to track those that financialization brought to US executives. (Dünhaupt, 2011) Nonetheless, institutionally, co-determination potentially limits upward movement of management salaries in German big business that financialization brings, which the American system of director primacy firm governance does not. More importantly co-determination limits the size of the gap between employees and executives in big firms. The most famous example is in the automobile industry (12% of the Germany economy) where German firms pay their workers twice as much as American. Sadhbh Walsche notes, for instance, that VW workers get paid $67 an hour in Germany but make under $20 in the VW plant in Tennessee. (Sadhbh Walshe the Guardian.com, Wednesday 19 February 2014, also see, Hargreaves, 2014) VW is not an exception among German firms. In Germany the employee elected works councils in the large firms, which have been around as have most of the firms on the German list since the co-determination regime began in the early 1950s, routinely negotiate wages and bonuses with management.

Still, the greatest difference in embeddedness, with respect to financialization, occurs at the level of the small and medium firms. In the US, start-up firms are an integral part of American folklore, for every start-up dreams of one day going public, like Microsoft or Facebook, and turning their founders into billionaires. No matter if the firm's business incomes do not produce the earnings of top executives, the system of financialization that Wall Street presents, permits billionaires to happen. "Too much profit orientation, too much financial sophistication, too much profit pressure emanating from capital markets" occurs (Dünhaupt, 2011, 19).

Few of the financial metrics (about a firm's stock price, about its achieving financial "expectations," or the firm going public) that business television journalists discuss with the financial experts they constantly interview on the evening business news have anything much to say to the German *Mittelstand* and the banking systems they use. German *Mittelstand* firms remain largely unincorporated; no stock option pay regime possible there. German SMEs are primarily self-financed out of earnings, or regionally through traditional bank loans from savings and cooperative banks.

Nor are family-owned German businesses victims of leveraged buyouts by private equity companies, which are integral to American financialization. The conversion rate of these quite successful German SME firms into public owned companies is very low; **i**n Germany from 2000 to 2007 only one percent of successor arrangements for founder or family-run firms involved private equity buyouts. (Schmohl, 2009, 4) Takeovers by foreign private equity firms are in fact particularly disliked. "Although many family businesses are going through generational changes," Josh Kosman writes, "...few have sold out to foreign Private Equity firms" (Kosman, 2010, 168). Germany ranks lowest among the European countries with regard to foreign private equity buyouts.

Not much evidence about SME financialization can be garnered indirectly either, through, for example, information about a family-owned firm's adoption of professional management. Germany's SMEs try to avoid the Buddenbrooks-effect (having incompetent offspring take over from competent founders) by hiring professional managers. But the firms do not seem to adopt the outlook of a professional management caste like that in America. Instead, they usually operate under hybrid management (family+professional managers) from which they profit from management expertise while the firm's metrics are set by owner-families not

professional managers, who in the US under financialization engage in short-term profit maximization and cost cutting at the expense of the workforce.

Rather, the *Mittelstand* firms strive for sustainability within a valued community. The factors supporting this goal become their all-important metrics and they are, like the pillars of banking on which they rely, primarily local and regional not national. Because German SMEs seek sustainability, they make implicit life-time commitments to their employees that they carefully recruit and train, relying on local networks. SMEs consistently consider labor a fixed asset, a human capital, and reject the notion that it is a variable cost that needs to be minimized. Since manufacturers know that sustainability demands staying abreast if not ahead in technology, the firms invest five percent of their revenues into research and development (Vernohr and Meyer, 2007, 29). They also exploit available scientific knowledge and knowhow by working with people in local universities and polytechnics (*Fachhochschulen*), research institutes, and in special places like the Fraunhofer Institutes set up throughout Germany, to facilitate the transfer of scientific research into innovative products and services mainly in *Mittelstand* firms. To promote worldwide success in niche services and manufacturing, on which they concentrate, German SMEs devote much time to cultivating customer relations, owners often making repeated foreign trips in order to establish and maintain personal contacts with customers. Through their business activities German *Mittelstand* firms make high incomes for their owners, but they do it through business activity, not financialization.

Educational systems

I have been publishing articles and books about the comparative development of engineering and business education in Germany, France, the UK, the US, and Japan for over thirty-five years [the first, in 1977, "Industrialisierung und Erziehungssystem in Frankreich und Deutschland vor dem 1. Weltkrieg." *Historische Zeitschrift*, 222, 265-96; the most recent, in 2011, "Reform of Finance Education in US Business Schools," *Real World Economic Review* 58 (December), 95-112.] Since it has been America's great contribution to education, it should be no surprise that the discussion has focused to a large extent on US contributions to business and management education and how they reflect in and foster the transformation in national and international business. Already in 1949-50, 617 US institutions offered courses in business and commerce to 370,000 undergraduates, almost twice as many students as those studying engineering. But the most impressive innovation has come in graduate education – with the big business schools, Harvard, Wharton, Carnegie-Mellon, Chicago, MIT, Georgia Tech, UCLA, Stanford, and a few others leading the pack -- 4,924 MBAs graduated in 1960, 23,400 in 1970, 70,000 in 1980s in a continuous expansion up a steep curve (Locke, 1996, 28). Business school deans and faculties were not shy about cultivating relations with CEOs or about adapting their programs to their needs. Locke and Spender, leaning on Rakesh Khurana's solid study, note how they have also done so in the era of financialization:

> "MBAs increasingly found jobs in the banks, hedge funds, and investment houses of the expanding sector. Khurana, cites a survey of first jobs for graduating Harvard Business School students: Between 1965 and 1985 students' entry into financial services and consulting 'rose from 23 percent to 52 percent' of graduates (Khurana, 2007, 328-29). The same shift happened in 'other elite schools, such as Wharton and the business schools at Stanford and the University of Chicago.' By 2005 'among the 180 principals and managing directors in the 20 largest investment firms, 73…[held] an

> MBA from one of the six elite schools (Harvard 51, Chicago 7, Columbia 6, Stanford 5, Dartmouth's Tuck 3, and Northwestern 1)'" (Locke & Spender, 135).

The system's capacity to expand internationally depended on the receptivity of host countries. In the UK, although without a business school tradition, the MBA idea took hold, first in London and Manchester, and then in a spate of business school creations primarily in the 1980s. In France, the schools of commerce also greeted the American study programs willingly, and the newly established (1968) French Management Education Foundation (FNEGE) developed a program to send hundreds of fledging French management professors to American and Canadian business schools to imbibe US academic management science. But in two countries the US MBA business school model made little headway: Japan and Germany.

With this fact in mind, I did a little survey in 1983 to try to clarify the basis of job recruitment in the United Kingdom, France, and Germany. I selected a prestige US management consultancy, the Boston Consulting Group, which did major business in these nations. I visited BCG head offices in each country and asked the people responsible for hiring consultants to work for them what educational backgrounds their recruits had. In France the answer was quick and clear; they only hired people from the *grandes écoles* (*Ecole Polytechnique*, *Ponts et Chaussées*, *Mines,* and *ENA*), since graduates from these schools would be running the firms using the consultancy. In London, the answer was a bit perverse. BCG was looking for "high flyers", very bright people who could talk to top executives in top firms about big problems, like strategy. The firm recruited its consultants from the best US business schools and Oxbridge, where at the time there were no business schools. Thus, despite the existence of London and Manchester business schools for almost twenty years, in 1983 the firm preferred to get people who had studied the classics (Greats) or PPE (Politics, Philosophy, and Economics) in Oxbridge. This mode of selection would probably upset people in elite business schools, because they think something taught by them is more useful to consultants than the classics, but it made sense as far as BCG clientele were concerned. A BCG consultant would deal with a social type (public school, Oxbridge) whose favor they would have to curry to succeed in their consultancy. To gain their confidence, to appear intelligent and capable, a consultant had to be liked by their clients. As in France, a person from the wrong school, with the wrong accent, would have an uphill struggle not because he/she were incapable or ignorant but because perceptions of ability and intelligence are socially shaped. Oxbridge fit that bill. (Interview results given at various places in Locke, 1989.)

At the Munich office of BCG the recruiter, Dr Struve, answered my questions with a lament. "In Germany there are no national prestige schools, like the French *grandes écoles*, the elite US business schools, or Oxford and Cambridge, that can screen out the best candidates for us. We have to do the screenings and interviewing ourselves from a large pool of candidates that have attended lots of good schools; we select not by school attended but by disciplines studied." When pressed on the issue, Dr Struve asserted that the favored candidates were engineers or economics-engineers (Wi-Ing., a study program composed fifty percent of engineering and fifty percent of business economics courses). This absence of nationally elite schools made recruitment more work for Dr Struve. When big German commercial banks in the 1990s decided to adopt the US-UK investment banking model, they even had trouble recruiting in Germany on the basis of disciplines studied. In Germany faculties of economics (*BWL*) studied finance, but finance professors did not have the contacts in investment

banking that prestige US business school finance professors (at Wharton, Harvard, MIT, Chicago, Columbia, Stanford, and others) had built up earlier in the era of US financialization. German commercial banks decided to develop the required expertise through acquisition. Deutsche Bank turned to the UK and the US to recruit staff well versed in the ways of capital markets, and it bought Morgan Grenfell, the British merchant bank in 1989 and Bankers Trust, the US specialist in hedge funds, in 1999. Dresdner Bank acquired UK-based Kleinwort Benson in 1995 and US-based Wasserstein Parella in 2000, attempting to expand into the global big leagues of underwriting, sales and trading, and merger advice. Deutsche Bank established its investment branch in London. To satisfy their educational needs, they drew substantially on those educated in America because of German educational deficiencies.

The key point about German education, however, is if ill equipped for financialization of the big German commercial banks, it was well equipped to serve the educational needs of the *Mittelstand*. This is true because Germans have a different conception of education from people in Britain and America. I explained an important aspect of the difference In "Reassessing the Basis of Corporate Performance," (*Real-World Economics Review*, 2013) I wrote:

> "Ian Glover notes that 'In Anglophone countries, two cultures, the arts and sciences are recognized.' In the two cultures engineering is placed in an inferior place within the science culture, and UK scientists looked down on engineering as an inferior subject for the less brilliant and gifted. Glover went on to note that in [Germany] rather than two cultures there are three: '*Kunst* (like the arts), *Wissenschaft* (similar to science) and *Technik* (the many engineering and other making and doing subjects, representing practical knowledge (*Können*),' including scientific knowledge (*Wissen*). (Glover, 2013, 9) In Germany a great chain of practical (tacit) education *(Können*), the art of practical work, topped off with knowledge (*Wissen*) gained primarily in technical *Hochschulen*, combined, in education and workplace, to define German engineering as this third culture of *Technik*. The German engineering society [Verein Deutscher Ingenieure (VDI*)*] has consistently pitched a large tent, including in its membership craftsmen, machinists as well as university educated engineers. They stood and stand as equal participants through their skills and knowledge."

Within the world of *Technik*, the justly famous German apprenticeship system forms the practical technical and commercial educational base. German secondary school students can and do enter into an apprenticeship, after grade 10, and work in an organized program four days a week on some approved occupation (chimney sweeping, bookkeeping, banking, metal working, machine operating – there are over 400 options), while still attending secondary school courses (e.g. in English, German, mathematics) two days a week, before they end the program, after three years, if successful, with an apprentice certificate in their specialty (*Fach*). This practical, tacit education is primarily carried out in *Mittelstand* firms. It is local, and can be continued up to the master craftman's level (*Meisterbrief*), a qualification that is highly respected in the German work world. Often first line supervisors in German factories have this qualification. A network of local institutions, in particular, the *quasi* public Chambers of Commerce and Industry are charged with administering the programs, and the employee-elected works councils in firms where pupils are apprenticed monitor the effectiveness of the training.

The apprenticeship certificate is not an educational dead end. There is the possibility of more extensive practical learning though the preparation of a *Meisterbrief* or to explore the more scientific dimension of *Technik* by enrolling in local technical and commercial schools. These schools have their roots in practical education, too, specifically because throughout most of the 20th century people had to have completed an apprenticeship to gain entry into them. Their students study for three years, alternating coursework with work stints in praxis. Despite the practicality of this education, the students through their faculties are also exposed to science, since the schools' teachers have to have degrees in subjects with a scientific input (explicit learning) from German universities (*Hochschulen*). Subuniversity graduates (originally Grad-Ing and/or Grad-Kauf, later Dipl-Ing FH and/or Dipl-Kauf FH) from these schools (now called *Fachhochschulen*) have consistently been highly sought after by German industrial firms; they rise to the highest positions in German industrial management.

Sixty percent of secondary school pupils participate in apprenticeship programs mostly in *Mittelstand* firms; among the forty percent who do not, ten leave school with poor qualifications while the other thirty percent finish their A levels (*Abitur*) and go on to study at university in great numbers. But unlike the American, British, and French elite who leave home for prestige schools and the national and/or international employment scene, the Germans, concentrating on subjects instead of the reputation of schools, stream into the excellent regional universities that are the strength of their university system, with every chance of remaining regionally oriented after their studies are completed, serving the educational needs of the *Mittelstand*.

If German *Mittelstand* incomes thrive, from the point of view of social justice it is a much better outcome than the exorbitant incomes the top one percent of Americans enjoy through financialization. Clearly German firms do a lot for their communities and are respected for it. This cooperative sense even extends to big firms where top executives do profit from financialization. While in the 1980s director primacy governance in league with the Republican politicians wrecked the social pact with workers in America, German conservative parties (CDU & CSU) never turned their back on co-determination; Helmut Kohl and Angela Merkel remain faithful to it. (Locke & Spender, 80) But more importantly, so do the employer associations; the German Employer Confederation and the Employer Association for the Chemical Industry (Bundesarbeitgeberverband Chemie), for example, opposed reforms at the end of the 20th century designed to advance the interest of firms and managers, which would have gutted co-determination. (Stahl, 60, Werder & Grundei, 101)

Conclusion

There are clear signs about what needs to be done to diminish the effect that financialization has on income distribution. It is obvious that the solution to the problem of excessive and wildly mal-distributed incomes is not to set up ethics courses for MBA students at Harvard, London, the Chicago Business School, and elsewhere (Locke, 2011b)**.** Solutions require the adoption of new public policies and legal-institutional change. They involve politics and are about grasping power. Nor should political control be sought primarily in underdeveloped and/or developing countries, where financialization wreaks havoc. The West is not driven by some financialization monolith; there are strong advanced economies, as the German example shows, and a political base, even within the business community, that is ready to oppose this juggernaut. To choose is simple: If people want to keep out undesirables from their community why just pass anti-immigrant or vagrancy laws; they need also to stop rich

financial interlopers in private equity firms from buying local firms and using bankruptcy statutes to deprive employees of their pension and benefit plans. They also need, like the Germans do, to give employee representatives on supervisory boards a voice in setting the salaries of top management and in firm governance, so that they can resist acquisitions and takeovers. It won't be easy; witness American workers' (under intense pressure from Republicans and the business community) recent rejection of the union at Volkswagen's plant in Tennessee, which spoiled the company's attempt to introduce a works council in the plant (Volkswagen is fully unionized with works councils included in its governance everywhere in its worldwide operations, except Tennessee).

Something needs to be done to counter the takeover of educational institutions by private interests. In the nineteenth century the Morrill Act (1859) set up land grant colleges throughout America "to promote the liberal and practical education of the industrial classes in the several pursuits and professions in life." They were, like the technical and commercial institutes being established in Germany, meant to promote the public good through agricultural and engineering education. The business school movement in the U.S. and its extension overseas has taken a different route. Already in his 1918 book *The Higher Learning in America: A Memorandum on the Conduct of Universities by Business Men*, Thorstein Veblen provided a critical perspective on the role of the schools of commerce (today called business schools) within the American university and, by consequence, their effect on the society as a whole. He asserted that "the college of commerce, if it is to live and thrive, may be counted on to divert a much larger body of funds from legitimate university uses, and to create more of a bias hostile to scholarly and scientific work in the academic body, than the mere numerical showing of its staff would suggest" (Veblen, 1918, 157). Furthermore, he wrote about the consequences that a "habitual pursuit of business" has on the ideals, aims and methods of the scholars and schools devoted to "the higher learning". Put simply, "The consequences are plain. Business proficiency is put in the place of learning" (Veblen, 1918, 142 in Robert Kemp, 2011). He might have added business proficiency is put at the service of the perpetuation of a moneyed elite, for these schools, where tuitions range up to $100,000 a year, are private welfare clubs for the upper classes, supported with lavish endowments from businessmen for the schools' academic chairs and the schools themselves. Financially hijacking public institutions to promote private greed is not philanthropy for the public good (Locke, 2012, 110-11). It is part of financialization and should be appropriately dealt with in the tax codes. Germans call the purpose of higher education *Wissenschaft* (scientific investigation). Follow them. Need more be said?

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SUGGESTED CITATION:
Robert R. Locke, "Financialization, income distribution, and social justice: recent German and American experience", *real-world economics review*, issue no. 68, 21 August 2014, pp.74-89,
http://www.paecon.net/PAEReview/issue68/Locke68.pdf