

## The New Financial Capitalism

The American economy has undergone fundamental changes in the three decades leading up to the financial crisis of 2008. Some of these changes were visible to everyone—the explosion of information technology and the increasing globalization of trade, for instance. Other changes were initially subterranean but potentially more consequential. A revolution in finance has encouraged more people than ever before to participate in financial markets, from buying mutual funds to refinancing their home mortgages. It has also vastly expanded the domain of what can be bought and sold, from plain-vanilla stocks and bonds to mortgages, credit card receivables, student loans, payouts of insurance contracts on the terminally ill (“viaticals”), future lawsuit settlements, and opaque derivatives such as collateralized debt obligations and credit default swaps. As more things are traded on financial markets and more households participate as buyers and sellers, directly and indirectly, finance has seeped ever deeper into the fabric of everyday life. This book is about how the financial revolution has re-ordered American society through its effects on corporations, financial intermediaries, governments, and households. My core argument is that financial markets have shaped the transition from an industrial to a post-industrial society. For most of the twentieth century, social organization in the United States was shaped by the gravitational pull of the large corporation. It is now oriented around financial markets to a degree that was almost unfathomable until it was revealed by a global economic crisis.

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Large corporations were the dominant social institution in American life for generations. From their abrupt emergence at the turn of the twentieth century until the takeover wave of the 1980s, a few dozen corporations came to control most of the nation's industrial assets and to employ a sizeable part of the labor force. Along the way, they re-formatted society in their own image, turning an agrarian society into an industrialized world power. At the end of the nineteenth century, nearly half of the nation's workforce was dispersed among 6 million farms. Five decades later, fewer than one in six worked in agriculture, while manufacturers—mostly corporations—employed almost half of the non-governmental workforce. The large industrial corporation had become the organizing structure for economic and social life, exerting a gravitational pull on the character of industrial society. The employment practices of these firms formed the careers and broader life-chances of individuals and households, their choices about how and where to expand shaped regional economies, and their charitable donations and community involvement determined the character of cities. *Fortune Magazine* drew out the political implications of this situation in 1952: “Any President who wants to run a prosperous country depends on the corporation at least as much as—probably more than—the corporation depends on him. His dependence is not unlike that of King John on the landed barons of Runnymede, where Magna Carta was born.”

Yet by the early 1970s, the passing of industrial society was in sight, and with it the dominance of the large corporation. When sociologist Daniel Bell described the post-industrial society in 1973 as one in which “the majority of the labor force is no longer engaged in agriculture or manufacturing but in services,” the US was the only country where this was the case—about 60% of Americans were employed in services. Today, the transition to post-industrialism is nearly complete in the United States. Agriculture and manufacturing combined account for a mere 11% of the workforce (and falling). Retail employment surpassed manufacturing by the turn of the twenty-first century, and Wal-Mart alone now employs more American workers than the dozen largest manufacturers combined. At the height of the real estate bubble in 2006, there

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were more real estate agents than farmers, more mortgage brokers than textile workers. The employment practices of large manufacturers and other bureaucratic firms, which once set the standard for middle-class life in America, are irrelevant for most of the population, and the idea of an organization providing a career of stable employment has been banished to civil servants and that sliver of academics with tenure. Many of the core firms of the mid-twentieth-century US economy—AT&T, General Motors, US Steel, Westinghouse—have either disappeared or substantially retrenched, and whatever influence on public policy they may have had is long gone.<sup>1</sup>

As large corporations have lost their gravitational pull on the lives of their members, another orienting force has arisen: financial markets. Fewer than one in ten households owned corporate shares at mid-century, and nearly half of those owned stock in only one company—often the household head’s employer or the local utility company. Fifty years later, over half of American households were invested in the stock market, usually through diversified mutual funds. Corporate pensions that once paid specified benefits to employees upon their retirement from the company, thus tying them to a particular employer, had been replaced by portable 401(k) plans owned by the employee. The growth of stock ownership was particularly striking among the young: where one in eight households headed by someone under 35 was invested in the stock market in 1983, half were in 2001. If their parents had made a losing bet on a lifetime of employment at AT&T or Westinghouse, then this generation was not about to entrust their future to a career at Pets.com or Wal-Mart.<sup>2</sup> The bonds between employees and firms have loosened, while the economic security of individuals is increasingly tied to the overall health of the stock market.

The administration of George W. Bush sought to institutionalize this transition through a set of initiatives—labeled “the ownership society”—that became a centerpiece of Bush’s second term agenda. The most notable effort was a plan to partially privatize Social Security by allowing individuals to invest a portion of their government-mandated retirement savings in the stock market rather than in the government’s

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trust fund—essentially creating 401(k) plans for everyone. In his second inaugural address, the president stated: “We will widen the ownership of homes and businesses, retirement savings and health insurance—preparing our people for the challenges of life in a free society. By making every citizen an agent of his or her own destiny, we will give our fellow Americans greater freedom from want and fear, and make our society more prosperous and just and equal.” As “agents of their own destiny,” individuals would no longer rely on corporations or governments to vouchsafe their economic well-being: they would rely on financial markets. Just as the transition from feudalism to market capitalism had turned peasants into wage laborers, the transition from an industrial to a post-industrial society would turn corporate employees into shareholding free agents. This vision was particularly remarkable given that, as Bush spoke, the American household savings rate had turned negative for the first time since the Great Depression. Instead of investing their wages in the stock market, households had come to rely on increases in the value of their asset ownership—homes and stock portfolios—to fund consumer spending that outstripped their employment income.<sup>3</sup> As we shall see, when individuals come to see themselves as free-agent investors, the consequences for society can be dire. When home mortgages are regarded as stock options on a grand scale, for instance, entire neighborhoods can be dragged down by a few underwater mortgages.

This book is about how these trends are connected—about how financial markets have shaped the transition from a corporate-industrial to a post-industrial society in the US. I argue that many seemingly disconnected developments are shaped by the same underlying forces. The expansion of financial markets into ever broader domains has changed the organization of society in myriad ways, from the governance of corporations and states to the daily decisions of households. When Adolf Berle and Gardiner Means, a lawyer and an economist, announced the arrival of corporate capitalism in the early 1930s, they claimed that corporations were becoming the dominant institutions of the modern world, drawing the rest of society into their orbit. This imagery of a corporate-centered society held sway for decades and informed the

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understandings of social theorists and the larger public. But the shift to a post-industrial economy has displaced this familiar corporate order with one oriented toward financial markets and their signals.

The change is, in a sense, a Copernican revolution. Copernicus is credited with showing that the earth was not the center of the universe, and that the earth and the other planets in the solar system revolved around the sun. By the same token, from a social system orbiting around corporations and their imperatives, we have moved to a market-centered system in which the corporations themselves—along with households and governments—are guided by the gravitational pull of financial markets. As industrialism has given way to post-industrialism in the US, financial markets have re-formatted the institutions of the corporate economy and oriented corporations toward shareholder value as their guiding star. Moreover, the changes have spread from the corporate sector to the broader society, from choices about what kinds of housing will be built to how people perceive their economic interests when they vote. This shift is perhaps a generation old—its start might be dated to 1982, with the simultaneous advent of the first hostile takeover wave, the 401(k) plan, and the Third World debt crisis—and is not yet complete. But we can outline its emerging forms now. It tied the well-being of American society to financial markets to an unprecedented degree. With the economic meltdown of 2008, corporations, financial institutions, local governments, and households all found themselves whipsawed by financial forces beyond their control, and perhaps beyond their comprehension.

American corporations were the proverbial canary in the coal mine, as the takeovers of the 1980s and the shareholder value-driven “downsizings” of the 1990s hinted at what was to come. The corporation itself is ultimately a financing device, and a creature of financial considerations. As a result, corporations vary substantially among different countries according to how financing is organized, whether primarily by banks, markets, or some other combination. Because generations of companies in the US have relied on stock and bond markets for their financing, American corporations have long been in the vanguard of changes

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associated with financial markets. As Berle and Mean described, dispersion of corporate ownership early in the century brought about a shift in the nature of property—in their memorable metaphor, it had “split the atom of property”—and left the corporation’s nominal owners holding merely a partial claim on uncertain future cash flows. During the restructurings of the 1980s and 1990s, the corporation was again transformed from a social institution to a mere contractual fiction oriented toward shareholder value. Through trial and error, those that ran corporations learned what the stock market values and what it disdains, resulting in a wholesale redistricting of the industrial map into a format tailored to the requirements of the market: manufacturing conglomerates, for example, became variously broadcasters (Westinghouse), casino operators (ITT), and banks (GE). Shareholder value—shorthand for being guided by what the market values—thus set the laws of motion of the corporate economy.

As financial markets extended their reach beyond the corporate world, more aspects of social and political life were drawn into their rhythms. From corporate shares to home mortgages to insurance and lawsuit settlements bundled into securities, ever more members of society participated in financial markets, directly and indirectly, as buyers and sellers. And as they did so, the thoughtways of finance became more widespread. What emerged can be called a *portfolio society*, in which the investment idiom becomes a dominant way of understanding the individual’s place in society. Personality and talent become “human capital,” homes, families, and communities become “social capital,” and the guiding principles of financial investment spread by analogy far beyond their original application.

The portfolio society is in some sense the doppelganger or evil twin of Bush’s ownership society. The term *ownership* evokes the family farmer working his ancestral land, patiently improving his patrimony for future generations. But portfolio ownership means something very different. Owning shares in a widely held corporation merely gives a fractional claim on future residuals and pointedly excludes real control. Portfolio ownership—through mutual fund shares and 401(k)s, the most common

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pattern today—entails a fractional claim on a set of fractional claims held by an intermediary institution such as Fidelity or Vanguard. Moreover, some of these claims may be on things quite obscure to their ultimate beneficiaries—bonds backed by mortgages or toll road collections on another continent, or by David Bowie’s album sales. “Property” and “ownership” in this context are those of the arm’s-length investor, not the vested interest of the farmer or factory owner.

The disruptions that accompany rapid market expansion (or contraction) provoke changed ways of thinking about social relations. In Shakespeare’s time, as the social implications of the market economy were being worked out, buyers and sellers were seen to be intrinsically in conflict, and markets turned their participants into actors in a theater of misrepresentation. Adam Smith argued, in contrast, that markets bring out the best in participants: in spite of themselves, sellers are led to provide things that buyers are willing to purchase voluntarily and to become more virtuous along the way, leaving them both better off. Karl Marx saw markets stripping away sentimentality and leaving people to perceive all social relations to be, at bottom, economic exchanges. Ultimately, everything was for sale. But transactions on financial markets are rather different from those on other markets, from what is sold to how prices are set. Capital assets are promises, claims on the future, and are marketed and evaluated according to peculiar rules. *Investors* are different from other buyers; *issuers* are different from other sellers. As more of society is securitized and more households became investors and issuers, willingly or unwillingly, more of social reality is drawn into the financial nexus.

Portfolio thinking has penetrated deeply into our social institutions. For “investors,” the common sense of financial prudence—diversify and maintain adequate liquidity—spread to the many forms of capital in which they invest, including human capital and social capital. The prudent investor avoids concentrating his or her portfolio on particular asset holdings (jobs, homes, friends, communities). For “issuers,” the requirements for appealing to investors acts as an invisible hand in creating conformity to the market’s standards. For US corporations,

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this has meant creating a system of corporate governance purported to focus management attention on shareholder value as the ultimate scorecard. The market values visibility (“transparency” in governance and operations) and commensurability (that is, making things that are traded comparable to each other). Transparency is sometimes observed in both its meanings. Thus, corporations have shifted from social institutions to mere networks of contracts, and states—following the lead of corporations—have increasingly shifted from sovereigns to vendors competing in the marketplace of laws and contracting out tasks beyond their “core competence.”<sup>4</sup>

The remainder of this chapter gives a glimpse of where we have been and where we are headed. The rest of the book provides a more detailed discussion of the trends outlined here, and what it means for American society.

**The emergence of corporate society**

The American corporate economy of the twentieth century, with large-scale industrial firms owned by dispersed shareholders, originated through a confluence of factors in the late 1800s. At the beginning of that century, incorporation was granted by state legislatures on a case-by-case basis to enterprises deemed worthy due to their benefits to the public—turnpikes, canals, and other such public works. Over the course of the century, general incorporation statutes spread widely among the states, allowing individuals to form corporations for essentially any business purpose. The need for large-scale investment encouraged railroad corporations to raise capital on stock exchanges, and they were largely responsible for the growth of American financial markets in the second half of the nineteenth century. Manufacturers, in contrast, played a relatively trivial role in financial markets prior to the end of the century. But a wave of industry consolidation at the turn of the century—driven by antitrust laws, managerial and technological considerations that favored massive scale, and financed by bankers with a strong preference for publicly traded corporations—created dozens of professionally managed oligopolists with dispersed shares traded on the stock market. Thus,

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the two distinctive features of the American corporate economy—grand scale and public ownership—emerged together at the turn of the twentieth century and decisively shaped its trajectory.<sup>5</sup>

Large industrial corporations quickly became a dominant economic force in the US, and after the First World War the principles of mass production spread widely, as even the new Soviet Union emulated the low-cost production methods of Henry Ford. The limits of vertical integration appeared quite distant. Ford's River Rouge plant in Detroit, for instance, employed 75,000 people when it reached scale in 1927, turning iron ore, coal, sand, and rubber shipped from Ford-owned mines and plantations on Ford-owned ships and trains into steel, glass, and other components, and ultimately into Model A cars.<sup>6</sup> The bureaucratic techniques developed to manage large-scale vertical integration were extended to allow expansion into related industries, and the creation of the multi-divisional structure ultimately led to the conglomerate in the 1960s and 1970s—a sort of *reductio ad absurdum* of the corporate growth imperative.

Dispersed corporate ownership was a less obvious development than large size. Early on, J. P. Morgan and other bankers served as corporate directors of the companies with which they did business, and Louis Brandeis's *Other Peoples' Money* in 1914 documented a "Money Trust" that dominated the corporate economy through tentacles spread among the top tiers of industry. Bank-centered corporate systems had arisen in Germany and other industrial economies as well. But within a few years, bankers in the US had largely withdrawn from the business of overseeing corporations, and ownership became increasingly dispersed as members of the general public flooded into the stock market during the 1920s. In their 1932 book *The Modern Corporation and Private Property*, Berle and Means described two trends that the new "corporate system" had wrought: corporate control was centripetal, accumulating in the hands of management, while ownership was centrifugal, becoming increasingly dispersed among thousands of anonymous (and powerless) stockholders. As they portrayed it, both trends would continue through the indefinite future, leaving a relatively small class of professional managers

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in command of most of the nation's economic resources. This was "managerialism," a corporate system analogous to the medieval feudal system, with management as the new nobility.

In other nations, large firms were often owned or strongly influenced by governments. European states such as France had grown up long before the industrial corporation, and they were able to shape the developmental path of the corporate economy. But in the US, the opposite was the case. David Vogel points out that "Not until the late 'thirties did the annual revenues of the federal government rival those of the largest industrial corporation . . . In the United States the professionally managed, oligopolistic, multidivisional firm literally exists for a generation without the modern equivalent of the state."<sup>7</sup> The autonomy of the large American corporation and its professional managers was perhaps unique in the world.

Without constraint from shareholders or from a weak Federal government, how would the new corporate nobility use its power? Berle and Means saw several possibilities. One was that the new professional managers would continue to pursue maximum profits—perhaps the least likely possibility. They might instead pursue naked self-interest, staffing the board of directors with compliant cronies that would provide them with rich pay and perquisites detached from hard effort. Alternatively, the professionalization of management might create a commitment to the corporation itself as an institution endowed with responsibilities to employees, customers, communities, and other stakeholders (as they would be called today)—in short, *noblesse oblige*. By the 1950s, academic commentators agreed that, for the most part, managerialism had followed this last path, even as the trends toward increasing concentration of control and increasing dispersion of ownership continued unabated. Economist Carl Kaysen described how the "soulful corporation," freed from the demands of shareholders for maximum profitability, had become an institution run by benevolent elites. "No longer the agent of proprietorship seeking to maximize return on investment, management sees itself as responsible to stockholders, employees, customers, the general public, and, perhaps most important, the firm itself as an

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institution.” Moreover, “The whole labor force of the modern corporation is, insofar as possible, turned into a corps of lifetime employees, with great emphasis on stability of employment” and thus “Increasingly, membership in the modern corporation becomes the single strongest social force shaping its career members.” And even critics such as sociologist C. Wright Mills agreed that finance had little influence on the modern corporation: “Not ‘Wall Street financiers’ or bankers, but large owners and executives in their self-financing corporations hold the keys of economic power.”<sup>8</sup>

Thus, events around 1900—mergers creating large-scale, vertically integrated manufacturers, and the use of stock markets to finance them—set in train the development of the American corporate economy, with its distinctive contours and institutions, which reached its mature state by mid-century. The managerialist industrial corporation was, as management theorist Peter Drucker put it in 1949, “the decisive, the representative and the constitutive institution” of a new social order in the US.<sup>9</sup> But it was not a *permanent* institution, as its two bases—vertically integrated production and managerial indifference to financial markets—would quickly erode as the US transitioned from an industrial to a post-industrial economy in the 1980s and 1990s.

### **Post-industrialism and the decline of managerialism**

Several interrelated developments in technology and trade ushered in an era of post-industrialism, and with it the decline of the vertically integrated managerialist corporation. Information and communication technologies (ICTs), including computers, the Internet, and mobile telephony, changed both the kinds of products that could be created and the cost profile of different organizational arrangements. These technologies expanded the feasible forms and locations of production and distribution and allowed trade in “weightless” products outside of traditional territorial boundaries. Behind even the simplest products, there are often global supply chains: a t-shirt might be made of cotton grown in Texas from crops bio-engineered in Boston, sent to China for milling, sewn in Mauritius, silk-screened in Mexico, and sold to the final consumer

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at Wal-Mart, travelling at various times by ships bearing the flags of Panama or Liberia.<sup>10</sup> More complex products such as mobile phones or high-end fashions typically entail real-time coordination among components along the supply chain via the Internet.

Transactions that would have been protected within a single organization's boundary in the industrial era are more cheaply outsourced across organizational and national borders today. "Original equipment manufacturers" (OEMs) routinely subcontract for the design, manufacture, sale, and delivery of products bearing their brand, from computers to hot dogs. An entire sector of generic electronics manufacturing firms, such as Flextronics, SCI Systems, and Jabil Circuit, expanded in the 1990s to free OEMs from actually making things. Solectron assembled and distributed high-tech products such as routers, cable modems, and cellphones for firms like Cisco and IBM, and expanded by buying production facilities from Hewlett-Packard, NCR, Mitsubishi, and Sony and running them itself. Even the smallest tasks can often be outsourced to take advantage of specialization and economies of scale made possible by ICTs.<sup>11</sup> McDonald's hires remote call centers to take orders from drive-through customers at restaurants around the country and to convey them back to the kitchen over the Internet. The minimum-wage call center operators can be more effectively monitored for efficiency and disciplined than on-site employees.<sup>12</sup> Today, the value chain in Adam Smith's famous pin factory would undoubtedly span a half-dozen contractors across three continents.

New spaces are complemented by new products and new ways of consuming them. The digital technology that initially allowed music companies to sell compact discs for twice the price of LPs later enabled intrepid users to bypass purchase entirely and share music peer-to-peer over the Web, for later download to MP3 players. Internet pornography begat mobile phone porn. And entirely new categories of products have been enabled by jurisdictional legerdemain, such as Internet casinos whose parent companies are traded on the London Stock Exchange but operate in Gibraltar to avoid legal entanglements.<sup>13</sup> "Weightless" products are

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effectively placeless as well; nationalities and organizational identities are fungible.

The re-globalization of trade, following a long hiatus after the First World War, achieved multi-trillion dollar levels and elevated China to a world manufacturing center. Containerized shipping, a relatively simple technology, was largely responsible for this increase, as 90% of global exports travel by sea, and now half the retail goods sold in the US arrive by ship.<sup>14</sup> Cross-border trade and financial flows have changed the relations among states and corporations and the very meaning of “nationality.” Corporations are able to fine-tune where they house their production to manage labor costs; their intellectual property and legal place of incorporation to manage tax rates; their securities for access to capital markets; and their headquarters for year-round access to golf.

In the industrial era, the corporate imperative for growth meant more sales, more employees, and more industrial “territory.” This impulse was realized by Henry Ford in vertical integration all the way back to iron mines and rubber plantations; for the conglomerateurs of the 1960s and 1970s, it meant acquisitions in any industry that would help feed their expansion. But the size that matters for the shareholder oriented company is market capitalization, ideally achieved with as few tangible assets as possible. Information technology has greatly enhanced the ability to outsource various steps of the production process and to keep track of quality, from the design, manufacture, and distribution of products to human resource management. The hurdle for vertical integration is high, and external market comparisons are readily available, such that few functions within an organization are indispensable.

Information and other technologies, along with the globalization of trade and finance, have given rise to post-industrialism—a situation in which manufacturing and agriculture account for a vanishingly small part of the American labor force, in favor of services. But “post-industrialism” does not mean that nothing is manufactured or grown in the United States. Indeed, the US still leads the world in manufacturing value added: at roughly 24%, its share of global manufacturing

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has declined only minimally in two decades. Offshoring and the use of undocumented labor account for some of the declines in employment in these sectors. But more importantly, gains in productivity mean by definition that fewer people can produce more things, a trend showing every sign of continuing indefinitely around the world.<sup>15</sup> Put another way, it is hard to imagine circumstances that would bring back stable employment in large-scale manufacturers for a significant number of Americans.

The combination of these developments could have resulted in any number of different corporate forms. The Nobel Prize-winning economist Ronald Coase commented in 1937 that the telephone had enabled a vast expansion in the scale and scope of firms; by analogy, the Internet might have encouraged conglomerates to grow ever larger and more diverse, with GE, Westinghouse, and ITT battling for supremacy. Yet quite the opposite has occurred, as the concentration of assets and employment among large firms has declined since the early 1980s (Walmart notwithstanding) and the modal corporation is quite industrially focused. The reason for this is the ongoing financial revolution.

**Reflections on the revolution in finance**

The new information and communication technologies that have transformed manufacturing and services have perhaps had an even greater impact on finance, and in particular on the ability to trade assets on markets. ICTs have enabled dramatic changes in how finance is done: more information is available to allow valuation of more kinds of securities; trade has expanded in scope, allowing individual investors to buy and sell securities from around the world through their mobile phones; and financial innovations are generated at a breakneck pace, greatly expanding the types of things that can be traded on financial markets—from shares of stock to home mortgages to natural disaster bonds to bundles of insurance contracts for the terminally ill. Economist Robert Shiller states that, thanks to information technology, economics today is “roughly where astronomy was when the telescope was invented or where biology was when the microscope was invented,” and the ferment

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of innovation in finance is palpable.<sup>16</sup> If trading bonds consisting of bundles of insurance contracts for the terminally ill seems exotic, then the future promises ever-stranger possibilities. Many securities today are effectively incomprehensible and can only be valued with the aid of computers—or not at all, as became abundantly clear when the crisis of 2008 left financial institutions with balance sheets full of financial instruments that were impossible to market, and thus in principle without value. Even sophisticated institutions with well-paid staffs of mathematical savants were at a loss to figure out what this stuff was worth.<sup>17</sup>

A primary driver of financial expansion was cost. ICTs greatly reduce the costs of financial transactions and of valuation. Those over 40 may recall standing in line at the bank to deposit their paycheck and to withdraw cash, and the hours of preparation required to have currency on hand for foreign travel. Those under 40 are more familiar with airport ATMs that accept cards from anywhere in the world and spit out locally denominated cash at an appropriate exchange rate. They may also have online brokerage accounts to buy foreign equities, researched with the help of Google and on-line tools for making sophisticated assessments and comparisons. Thus, the cover charge for participating in financial markets as an investor has declined dramatically. For those uninterested in playing the market directly, the cost of investing in mutual funds has greatly dropped over the past decades, making them a relatively inexpensive destination for household savings, and the number of households owning mutual funds increased from under 6% in 1980 to nearly half by 2005.<sup>18</sup>

The entry charge also went down for issuers of shares and other securities. Roughly 3,000 US companies made initial public offerings during the 1990s. In prior years, issuers usually had something of a track record—revenues, say, or products. During the 1990s, however, new firms with no profits and minimal revenues had little difficulty going public. Biotech firm ImClone, for instance, first sold shares to the public over a dozen years before it had a product to sell, and dozens of other biotech firms went public with similar prospects—nearly fifty in 2000 alone. From some perspectives, the ease of going public may

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have lowered the bar too much. Pets.com raised \$82.5 million through an IPO in February 2000 and spent nearly all of it to establish a brand name through costly advertising and discount offers for pet supplies sold online; within less than a year it was in liquidation, its credulous investors forsaken. Although the Sarbanes–Oxley Act increased the cost of being a public corporation, it did not entirely eliminate the enthusiasm for IPOs, and apparently had little impact on the sales of other corporate securities. Indeed, even companies in financial distress could access the capital markets by securitizing their receivables, whose credibility depends on the firm’s customers rather than on the firm itself.<sup>19</sup>

**Changing intermediaries**

A consequence of the lowered cost of using financial markets was a shift in the composition of the most important players in finance. In the US, commercial banks held a predominant place in the corporate ecosystem throughout the industrial era, and their boards of directors were gathering places for elite chief executives from the command posts of the economy. The board of New York’s Chase Manhattan Bank in the early 1980s included top executives from over a dozen major national corporations, including AT&T, Bethlehem Steel, Exxon, Pfizer, and Xerox. Outside the money center, regional banks held similar positions in their local networks. Bank of Boston’s board had top executives from Cabot, Gillette, and Raytheon, all major firms in Boston; First Chicago had executives from Chicago’s Amoco, National Can, and Quaker Oats; and Pittsburgh’s Mellon Bank had directors from Alcoa, Allegheny International, and Westinghouse.<sup>20</sup> If not the controlling hydra of Brandeis’s imagination, commercial banks were certainly well-connected to important sectors of the local or national economy.

All that changed in the 1980s and 1990s. In the simplest terms, the business of a commercial bank is to take in money from depositors, who are paid interest, and lend it out to creditworthy businesses, who are charged a higher interest rate. Profit comes from the difference between these two rates. But the banking *function* need not be done by

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organizations called “banks.” Banks are in the information business, and their historical advantage in financing businesses was superior access to information. But corporations increasingly turned to lower-cost financial markets for debt, beginning in the 1970s and accelerating in the 1980s. Demonstrably creditworthy borrowers found that they could turn to competitive markets for funds at lower cost; few doubted that AT&T or GM would be able to pay back their debts, and by the mid-1990s the value of commercial and industrial loans held by US banks was equalled by the value of commercial paper issued by firms. Information technology simply lowers the bar for being “demonstrably creditworthy.” Anyone can now get the kind of credit information formerly hoarded by banks, and the information benefits of a bank’s proximity to its customers are less often outweighed by the costs. Thus, much of a bank’s business could be automated and taken out of the fallible hands of human bankers. John Reed, CEO of Citibank at the time, predicted in 1996 that banking would shortly become “a little bit of application code in a smart network,” while Wells Fargo CEO Dick Kovacevich stated that “The banking industry is dead, and we ought to just bury it.”<sup>21</sup> (The mortgage crisis, which resulted in part from making “automated” mortgage loans through the use of computerized credit scores, ultimately ended up burying a large part of the industry—see Chapter 6.)

In response to their declining corporate lending franchise, banks began to move into fee-based services and, when regulations allowed, investment banking and other financial services. Moreover, thanks to the expansion of financial markets, banks found that they could re-sell business loans and other debt to get them off their balance sheet, just as they had done with home mortgages. Indeed, much of a bank’s assets, such as credit card receivables, could be securitized: bundled together and turned into bonds that could be sold on markets. Rather than being a repository for loans, banks were simply “originators” that could briefly hold debt before re-selling it on the market—the functional equivalent of what underwriters had always done. Just as original equipment manufacturers need not manufacture anything bearing their brand, banks need not hold any of the loans they had made on their balance sheet.

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Deregulation in the 1990s finally allowed the consolidation of the banking industry that had been delayed for decades by geographic and antitrust restrictions. As a result, a handful of regional banks grew to national stature. Charlotte, North Carolina, became an unlikely international banking center, housing two of the five largest banks in the US. Bank of America, # 1, was the entity that resulted from North Carolina National Bank's two-decade campaign of acquisitions, which culminated in its purchase of San Francisco's Bank of America in 1998 and Boston's FleetBoston in 2003. Its neighbor Wachovia Bank was # 4, also thanks to a massive acquisition spree begun by predecessor First Union; Wachovia in turn was acquired under duress in later 2008 by # 5, San Francisco-based Wells Fargo. And JP Morgan Chase resulted from the mergers of many of New York's (and the nation's) largest banks: Manufacturers Hanover and Chemical Bank in 1991, Chemical and Chase Manhattan in 1996, Chase and JP Morgan in 2001, and the combined firm with Bank One in 2004. At the end of this consolidation process, many cities found themselves without a significant locally based commercial bank, including Philadelphia, Los Angeles, and every city in Texas.<sup>22</sup>

Meanwhile, households had moved their savings from low-return bank accounts to money market funds and then, particularly during the 1990s, to equity mutual funds, and retirement savings shifted from corporate-managed "defined benefit" plans to employee-selected "defined contribution" plans largely invested in the same mutual funds. The number of US households with savings accounts declined from 77% in 1977 to 44% in 1989, while the proportion of households invested in mutual funds expanded from 6% in 1980 to roughly half by 2000.<sup>23</sup> "Savers," in short, became "investors." Mutual fund companies consequently gathered assets at a rapid clip, increasing from about \$1 trillion in 1990 to almost \$7 trillion in 2000. Most of the inflow of new investment went to a relative handful of "brand name" funds such as Fidelity, Vanguard, American, Putnam, and T. Rowe Price. As a result of the flood of new investment in the 1990s, mutual funds became the most significant corporate owners, and a handful of them amassed substantial ownership positions not seen since the days of J. P. Morgan a

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century earlier. Fidelity became the largest shareholder of roughly one in ten US corporations, owning more than 10% of several hundred companies.<sup>24</sup>

At the same time, deregulation enabled financial institutions to expand into diverse lines of business that increased their potential conflicts of interest. The mutual funds that owned shares on behalf of their investors were also selling benefit management services to the companies they invested in. Fidelity ran pension funds for hundreds of companies in which it owned (and voted) shares, and the company staked its future growth largely on managing health and retirement benefits and other outsourced human resource functions for corporate clients.<sup>25</sup> Commercial banks offered loans to companies (and their executives) that their investment banking arms were doing business with and that their analysts were recommending to their brokerage clients. Banks made personal loans totalling \$1.3 billion to WorldCom CEO Bernie Ebbers to fund his personal acquisition of a shipyard, a half-million acre cattle ranch, a trucking company, and timberland, among other things. Citigroup alone lent him more than a half-billion dollars, while its Salomon unit allocated him hundreds of thousands of “friends and family” shares for firms about to go public (and experience the usual first-day run-up in price). At the time, Salomon was WorldCom’s primary investment bank and, along with several other investment banks, earned millions in fees from WorldCom as Ebbers led a vigorous corporate acquisition program.<sup>26</sup> And investment banks provided merger and acquisition advice to firms in which their mutual funds held major investments. The market bubble of the late 1990s and the corporate scandals of the early 2000s were in part a result of the endless web of connections among financial service firms that created pervasive conflicts of interest in the finance industry.

**Efficient markets and the theory of the corporation**

Just as finance has undergone a revolution in practice, financial economics has seen a “Copernican revolution” in its theories of the corporation and their surrounding institutions. The center of this new

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approach to institutions was the efficient market hypothesis—the claim that financial markets generally get it right when pricing stocks, bonds, and other financial instruments. Financial markets are a species of prediction market, able to incorporate broadly dispersed information in evaluating the future prospects of a company or other traded entity and to update prices quickly. The result was that a company's share price was the best available guide to the consequences of corporate policies, a compass that told those inside and outside the company whether things were going in the right direction. This doctrine provided a compelling rationale for the re-orientation of companies toward shareholder value. Financial markets knew things that individual executives or bankers could not; as such, it was best to defer to their judgment.

A theory of corporate governance was developed to describe the internal and external devices purported to discipline corporate management and to orient them toward share price. If share price was a compass pointing toward True North, then corporate governance was a global positioning system making sure that those driving the car paid heed. Shareholder-elected boards of directors selected and oversaw executives at the top of the hierarchy; compensation systems tied to share price aligned executives' interests with those of shareholders; and an external takeover market ensured that those who failed to build shareholder value were shown the door. Outside accountants audited the company's books and verified to investors that the figures added up; financial analysts dug deeply into the company's operations and rendered informed judgments; and stock exchanges promulgated standards for listed companies to keep them disciplined. In combination, according to the theory, these and other governance devices channelled corporations in the pursuit of shareholder value. In many ways, this theory was the reverse of the analysis of Berle and Means, discovering a matrix of mechanisms that functioned to compel managerial attention to shareholder interests—many of them self-imposed by those same managers. Corporate elites were not feudal nobility, indifferent to their shareholder-principals, but the voluntary servants of the stock market.

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A distinctive feature of the new theory was that the corporation was no longer portrayed as a tangible institution with an inside and an outside, as in the industrial-managerialist days. Rather, it was a network, a “nexus of contracts,” organized in such a way as to promote the creation of shareholder value. It had no moral commitments to various stakeholders. Its commitments were those explicitly stated in written contracts with buyers, suppliers, and customers, or implicit in its status as a for-profit enterprise. Those companies that deviated from this model suffered the consequences, at first merely in theory, but later in reality.

During the hostile takeover boom of the 1980s, nearly one-third of the largest US manufacturers were acquired or merged, as the conglomerates assembled during the 1960s and 1970s were re-configured into industrially focused parts. Companies that started the 1980s producing goods in dozens of industries ended the decade producing in only one.<sup>27</sup> Some ended the following decade so focused that they no longer produced in any industry at all. Sara Lee divested many of its production facilities in clothing and food products to focus on brand management, following the model pioneered by Nike and Coke. Dozens of electronics companies such as Hewlett-Packard followed a similar path, relying on specialized “board stuffers” (so named because they originally did the low-value tasks of attaching components to printed circuit boards) to produce and ship the goods with their brand name on them. As the practices of outsourcing matured, corporations came to look more like the shifting nexus-of-contracts described in financial theory than the sovereign institution of the mass-production economy, a transition that generally enhanced their stock market valuations. Sara Lee’s CEO put it thus: “Wall Street can wipe you out. They are the rule-setters. They do have their fads, but to a large extent there is an evolution in how they judge companies, and they have decided to give premiums to companies that harbor the most profits for the least assets.”<sup>28</sup>

The new theory provided both a practical guide and a moral rationale for shareholder capitalism. As managerialism was replaced by an orientation toward shareholder value, this theory yielded policy implications

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for those in companies and governments. For companies, share price reactions upon the announcement of corporate actions provided immediate feedback on the wisdom of those actions, allowing firms to quickly change course when necessary to avoid the damages foreseen by the market.<sup>29</sup> Because the market was smarter than any individual participants, it was wise to pay heed; in any case, by the end of the 1990s executive pay was so tied to share price that no further rationale was needed. Like a referee at the World Cup, the market's judgment was right by definition, and resistance was futile. For policymakers, a central policy goal implied by the theory was to make sure that corporate control was contestable—that managers who failed to heed the signals of financial markets could be replaced without their consent. And the theory provided a blueprint, a potentially exportable model of how to run an economy to achieve the miraculous economic outcomes of the United States. Nobel Prize-winning economist Douglass North stated that a central puzzle of human history is why some economies flourish and others flounder. Financial economics had discovered an answer: economies that managed to sustain large capital markets—to fund businesses and guide their decision-making through appropriate systems of corporate governance—grew faster than others.<sup>30</sup> If missionaries in prior centuries exported eternal salvation through the doctrines of Christianity, their contemporary counterparts exported temporal salvation through the doctrine of shareholder value.

**Changing relations between corporations,  
financial markets, and states**

Corporations oriented toward share price cannot exist without institutional supports. Thus, law and economics theorists further reconceptualized the institutions that surround the corporation, including managerial labor markets, takeover markets, and the law itself. According to these scholars, shareholder value was not just True North for the corporation, but also for the institutions in which it was embedded, guiding their actions in hitherto unsuspected ways. An essential job of governments in the economy came to be seen as creating conditions

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appropriate for shareholder-value-maximizing corporations to do what they do. Moreover, financial market reactions became an increasingly important guide to governmental policymakers as it was for corporate executives, from the Philippines to Bill Clinton's America.<sup>31</sup> Clinton was famously responsive to the bond market, following the advice of his first Treasury Secretary Robert Rubin, a former investment banker. Like a CEO anxious to see how his company's share price reacted to the announcement of his latest restructuring, Clinton was highly attuned to financial market reactions to his policies. The proliferation of financial news networks helped enforce this attentiveness; when Bush spoke on Wall Street to lay out his administration's response to the corporate scandals early in his first term, cable news networks helpfully ran an electronic ticker tape crawl at the bottom of the picture to show the market's reaction (which, in the event, was negative—the Dow Jones Industrial Average dropped 2% the day of the speech—presumably due to the inadequacy of Bush's policy response).<sup>32</sup>

The parallels between governments and businesses went beyond their mutual attentiveness to financial markets. States were, in a sense, in the business of providing laws and regulations, and the new approach to law and economics pointed out that states were not monopoly suppliers. Consumers of laws are more or less mobile, none more so than corporations. Thus, states had to provide laws and regulations that their shareholder-oriented corporate customers were willing to buy, or those customers would shop elsewhere. Within the US, competition among states as providers of corporate laws had gone on for well over a century. American corporations are chartered by the states, not the federal government, and firms can choose where to incorporate regardless of where they actually do business. In the nineteenth century, New Jersey became the most popular state of incorporation after it allowed corporations to themselves own other corporations.<sup>33</sup> In the twentieth century, Delaware won the bulk of the incorporation business, and the revenues from this business provide a substantial part of the state's budget.

As competition among states for various kinds of corporate business expanded, governments correspondingly became more like

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corporations—less a sovereign than a vendor of laws, competing with other vendors to attract corporate customers. This was particularly evident for corporate finance. Securities and other financial instruments are weightless products, and their issuers have great flexibility in where they choose to register them. New Hampshire-based Tyco International re-incorporated in Bermuda in the 1990s, along with Accenture, Cooper Industries, Ingersoll-Rand, and several other firms, to take advantage of a legal system designed by American insurance companies a few decades before. The South Pacific island nation of Nauru created an international banking industry almost overnight that served as an entrepôt for Russian mobsters, who availed themselves of the looting opportunities created in part by Harvard economists. Liberia, whose ship registry was created by American oil companies seeking to avoid US labor laws, diversified into the incorporation business, attracting firms such as Miami-based Royal Caribbean Cruises. As a “foreign” ship operator incorporated in Liberia, it was not obliged to pay US income taxes, an obvious advantage for Royal shareholders such as Fidelity (which owned 9% of Royal’s shares in early 2005). And established ship registries such as Liberia and Panama faced new competition from cut-rate vendors like Bolivia, a land-locked country that nevertheless managed to bring in substantial revenues by registering hundreds of ships, no questions asked.<sup>34</sup>

Like corporations, vendor-states discovered the benefits of outsourcing. Liberia’s corporate and ship registry was housed in an office park in suburban Virginia, while American entrepreneurs bought up the rights to Internet national domain names like NU (Niue) and TV (Tuvalu). States honed their skills at brand management: following Britain’s lead to re-brand itself as “Cool Britannia,” dozens of nations and municipalities retained marketing consultants to aid their efforts to sell themselves to corporate clients, complete with logos and bullet-pointed value propositions. And vendor-states listened to their customers in designing their products. American International Group executives helped draft many of the laws that turned Bermuda from a backwater of the British Empire to the “risk capital of the world,” housing offshore operations of many of the world’s largest insurance companies as well as intellectual property

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subsidiaries used to shield overseas income from US taxes. Meanwhile, the US under the Bush Administration emulated the best practices of OEMs, doubling annual spending on contractors to \$400 billion for services ranging from operating cafeterias to allegedly interrogating prisoners at Abu Ghraib prison in Iraq.<sup>35</sup>

**Securitizing society**

Back at the household, Americans were instructed not to entrust their future to a company providing a career, but to think of their job as a setting to enhance their human capital while their financial capital accumulated. The 1990s provided a mass boot camp in stock market investing, and by the end of the decade over half the population had joined the army of shareholders. Tens of thousands of investment clubs sprang up across the country, and one of them—the Beardstown Ladies of Illinois, average age 70—parleyed their homespun investment wisdom into a bestselling *Common-Sense Investment Guide*, whose cover touted their 23.4% annual returns (later revealed to be 9.1%, as common sense apparently did not extend to correctly operating a spreadsheet). Members were drawn to the clubs by the prospect of attractive returns during the long bull market as well as by the low rates paid by banks and the uncertain prospects for Social Security and corporate pensions. The amounts that most households invested in the stock market were not especially large. Among US households invested in the stock market, the median portfolio was worth roughly \$36,000 in 2001 and declined to \$24,000 by 2004, far less than the value of the median family's home—or a new car, for that matter.<sup>36</sup> But the effect was highly disproportionate to the money at stake. People thought of themselves as *investors* and became far more attuned to fiscal policies (e.g. tax rates on capital gains) and financial market indicators such as interest rates.

Home mortgages also sensitized people to financial markets. The cost advantages of mortgage securitization meant that most mortgages were re-sold by their originators and bundled into bonds, perhaps to be purchased by overseas investors. Thus, as interest rates declined, almost half of the homeowners with mortgages refinanced them in the three years

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between 2001 and 2004, and a third of these borrowed additional funds to spend on home improvements, debt consolidation, and consumer goods (a phenomenon known as the “wealth effect”).<sup>37</sup> Homeowners were betting the (three-bedroom) ranch on their homes continuing to increase in value—an expectation that was catastrophically shattered for millions during the mortgage meltdown.

The effect of home mortgages becoming financial market commodities was somewhat paradoxical. Generations have regarded home ownership as a stabilizing force for communities. Homeowners are more likely than renters to vote, plant flowers, know the names of school board members, maintain their dwellings, and have children that complete high school without becoming pregnant.<sup>38</sup> The societal virtues of home ownership were praised by a long line of presidents, from Calvin Coolidge (“No greater contribution could be made to the stability of the Nation, and the advancement of its ideals, than to make it a Nation of homeowners”) to Franklin Roosevelt (“A nation of homeowners, of people who own a real share in their own land, is unconquerable”) to George W. Bush (“Just like that, you’re not just visitors to the community anymore but part of it—with a stake in the neighborhood and a concern for its future”). Savings and loan associations in the US were premised on the theory that saving to buy a home was a school for civic virtue and moral rectitude: “A man who has earned, saved, and paid for a home will be a better man, a better artisan or clerk, a better husband and father, and a better citizen of the republic.” And: “Thrift is a disciplinarian. It breeds virility. It strikes at sensuality, self-indulgence, flabbiness. It teaches the heroism of self-denial, temperance, abstemiousness, and simple living. It is the way to success and independence. It makes for happy homes, contented communities, a prosperous nation.”<sup>39</sup>

Yet through multiple rounds of refinancing, and debt structured to take advantage of the tax deductibility of mortgages, homeowners increasingly saw their home as just another financial asset, a piggy bank to fund a new flat-panel television. Financially, this made some sense at the time: the essence of diversification is avoiding over-reliance on particular assets, and outright home ownership left one perilously

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under-diversified. But from the community's perspective, highly committed and relatively immobile homeowners were the kinds of residents that voted in school board elections and joined bowling leagues with their neighbors. Thanks to the securitization of mortgages and the consequent ease with which homeowners could now extract whatever equity they might have built up, home buyers came to see their house as the equivalent of a stock option, which could be cashed in if the price went up or abandoned if it went down. An analyst at one bond rating agency said, "It seems there was a shift in mentality; people are treating homes as investment assets."<sup>40</sup> A generation of home buyers had been turned from ants to grasshoppers.

Thinking like an investor can have political consequences. Republican theorists discovered in the late 1990s that shareholders were somewhat more likely to see themselves as Republican than non-shareholders were, and thus a host of policies were proposed that built on this effect—notably a tax cut on capital gains and the plan to partially privatize Social Security by allowing workers to invest in shares rather than only government bonds. This latter plan appealed to current shareholders, but Republican activist Grover Norquist pointed out a further advantage: if shareholders vote Republican, then privatizing Social Security would create more shareholders, thereby making the Republican Party "a true and permanent national majority." While dismissed by many Democrats as implausible, this theory built on a long tradition of political thought stretching back to James Madison's writings in *The Federalist* # 10, where he argued that different kinds of property ownership lead to different "sentiments" and perceptions of political interests. Thus, rather than changing the party to appeal to voters' interests, this plan would change voters' interests to fit the party.<sup>41</sup> After the 2004 election, the Social Security plan flopped spectacularly, but it was not without effect. According to the American National Election Studies, whereas 31% of shareholders identified themselves as Republican in 2000, 39% did in 2004; among non-shareholders, the proportion of self-identified Republicans held steady at 18%. Moreover, while just over 50% of shareholders voted for Bush in 2000, 56% of them voted for Bush in 2004.<sup>42</sup>

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Portfolio thinking spread to how social theorists think of their subject matter. In an earlier era of market expansion, Karl Marx and Frederick Engels described how market relations had “stripped away the sentimental veil and revealed the family relation to be a mere money relation,” and the economist Gary Becker filled in some of the details. Having children, for instance, was like buying durable goods such as cars or refrigerators. In the 1990s social scientists began to describe human relationships not as consumer goods, but as capital assets. “Social capital” became a dominant metaphor, turning one’s family, friends, and community into investment vehicles, and joining “human capital” among the securitized categories of social life. Bowling in a league was not just a comradely way to spend an evening, but an investment that might yield rewards down the road. And joining the PTA was not just a way to build “social capital” with the teachers whose grades might validate the children’s “human capital.” Housing values depend on the neighborhood school’s showing on standardized educational tests, and so real money was at stake in how well the school educated neighborhood kids to fill in bubbles on rote exams.<sup>43</sup>

**The plan of the book**

My broadest assertion is that the expansive use of financial markets has shaped the transition from industrial to post-industrial society in the United States over the past three decades. I have described this as a Copernican revolution: where industrial society orbited around large corporations, post-industrial society—including corporations—increasingly orbits around financial markets and their signals. The remainder of this book details the arguments and evidence behind this claim. The next chapter describes the unprecedented expansion of financial markets in scale and scope in recent decades and its implications for how companies are run. For companies to be traded on the stock market there need to be systems in place to maintain a kind of discipline. I describe these systems as a functionalist theory of corporate governance and examine its links to the efficient market hypothesis in financial

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economics. I also discuss the limitations of the analogy between finance and other kinds of technology.

Chapter 3 describes the rise and fall of the conception of the corporation as a social institution in the US. I focus in particular on changes in the corporation since 1980, including the bust-up takeovers of conglomerates in the 1980s, the rise of the shareholder value movement in the 1990s, and the ensuing corporate scandals of the 2000s. In broad terms, the corporation has changed from an institution, with members, obligations, and sovereign boundaries, to a nexus or network. If the conglomerate represented the corporate growth imperative taken to its logical extreme, then the contemporary corporation has moved in quite the opposite direction, to an ephemeral legal fiction.

Chapter 4 analyzes how the most significant financial intermediaries have shifted from commercial banks to investment banks and mutual funds, as household savings shifted from low-interest bank accounts to retail stock funds and portable pensions. I describe bank consolidation and how it has affected the social structure of corporate elites in American cities, and how the logic of securitization has changed the basic function of banks. This chapter also details some of the conflicts of interest facing de-regulated financial intermediaries, such as mutual funds that run corporate pension plans, commercial banks that also do underwriting, financial analysts charged with following the clients of their employers, and investment banks whose brokerages retail shares of client firms and in-house mutual funds. The deregulation of finance has breached long-standing boundaries among formerly separate players, creating seemingly irresistible conflicts of interest that resulted in a rich diversity of scandals.

Chapter 5 describes the new place of states in a post-industrial world and how states have come to look less like sovereigns than like vendors of law, selling a product to corporate and other customers. This transition is exacerbated both by financial markets and their influence on state policy, and by footloose firms that can shop for jurisdictions. The global shipping industry provides a cautionary tale for the potential consequences

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of competition among vendor-states, and the effectively stateless world of the high seas offers some perspective on the prospects for a world in which institutions are a choice rather than a constraint. As vendors in a post-industrial economy, many states have increasingly emulated the practices of “network” corporations.

Chapter 6 analyzes what this all means for individuals, with their roles as employees, citizens, and voters re-imagined as “investors” in human capital, social capital, and political capital. Shareholders tend to follow different sources of news and to have different perceptions of their interests, from how they evaluate national economic policies to the values they seek to inculcate in their children. And homeowners have been encouraged to see their homes as an investment asset rather than a durable tie to a community. Portfolio thinking is thus evident in a number of domains beyond finance and has potentially large political and social consequences. The mortgage crisis of the late 2000s illustrates some of the unintended consequences of inducing citizens to think like investors.

The final chapter summarizes the argument and evaluates it in terms of the evidence drawn together in the previous chapters. Here I speculate more broadly on the potential consequences of the broad spread of portfolio thinking. Although I draw on systematic academic research wherever possible throughout the book, this chapter is more frankly speculative and suggests areas that citizens and researchers would do well to attend to in light of the current economic crisis.