

Financialization and Income Inequality:
How the Growth of Corporate Debt Undermined the Power of Organized Labor in the U.S.

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Chapter 1. Introduction

In recent decades, financial sectors accounted for a growing share of gross domestic product (GDP) in many developed countries, while financial institutions increased their stake in the total corporate profits reported in their economies. Nonfinancial corporations (NFCs) have come to depend more heavily on income from financial investments while paying out an increasing share of their profits as dividends to their shareholders, and financial markets have become increasingly central to the daily activities of households and governments. These developments are often grouped under the label of *financialization*, a term broadly understood to refer to growing size and importance of financial markets, financial institutions, and financial activities within the capitalist economy.

The advance of financialization coincides with a period of rising income inequality across many countries, evident in higher levels of Gini index, decline in labor's share of the national income, and increasing disparities between the income of top executives and the wages of average workers. In recent years, record levels of income inequality have raised concern even in such unlikely places such as the International Monetary Fund (IMF) and the World Economic Forum, which have often been accused of promoting economic policies that contribute to increasing levels of income inequality around the world.

Since the financial crisis of 2008, scholars have devoted a great deal of attention to the relationship between financialization and income inequality. This emerging scholarship provides strong statistical evidence of a close association between indicators of financialization and measures of income inequality at different levels of analysis. However, explanations of these findings are still rather limited, and tend to ignore the role of labor in these developments. The purpose of the present dissertation is to go beyond statistical analysis to examine how

financialization contributes to income inequality “on-the-ground”, at the level of workers, managers, shareholders and creditors.

The theoretical approach I adopt in this research differs from existing studies by exploring both financialization and income inequality from within the historical development of the class struggle. This does not mean that I treat “class” as a causal factor in the rise of finance, nor do I argue that financialization itself can be reduced to a set clearly identifiable class interests. Rather, the notion of class struggle is used here to indicate a specific framework in which the capitalist economy is understood to be based on an inherent conflict between labor and capital, i.e. between workers who are forced to sell their labor force and the capitalists who employ them. In classical Marxism, class struggle is often described as “the motor of history” (Wright 2002). For the purpose of the present research I settle for the more modest claim that the dynamics of the class struggle are essential for understanding the historical trajectory of capitalist economies.

Research questions

Inequality, of course, has always been one of the core research areas of sociology (Morris & Western 1999). Traditionally, the sociological study of income inequality was tied to broader questions of stratification and social classes. However, in recent decades the notion of class has been largely absent from research on income inequality, as the scholarly focus turned to other factors such as technological change, education attainment, and globalization (Wodtke 2016). This shift of attention can be partially explained as a response to the theoretical difficulties associated with the category of “class”, which many scholars have deemed too ambiguous and lacking in theoretical specificity. However, it is noteworthy that this retreat from class-analysis occurred around the same time when politics in the U.S. “took on a particularly blatant class character” (Wright 1994: 88), a shift that many critical scholars associate with the ascendance of

neoliberalism (e.g. Duménil & Lévi 2006; Harvey 2011; Panitch & Gindin 2012).

While the meaning of income inequality is relatively straightforward, financialization is a more recent term that still lacks a clear and widely accepted definition. In its broadest sense, financialization is understood as “the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies” (Epstein 2005: 3). According to a narrower definition, financialization refers to “a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production” (Krippner 2005: 174). For some scholars, financialization reflects the growing dominance of financial actors over the “real” economy (e.g. Orhangazi 2008; Stockhammer 2012). Others relate the term to the growing size and liquidity of financial markets (e.g. Aglietta & Rebérioux 2005). In short, financialization is a broad label that covers various empirical phenomena at different levels of analysis (van der Zwan 2014).

Both financialization and income inequality have received much attention within and outside the academy. However, research on the relationship between them is still relatively modest. Much of this emerging literature is located within the heterodox school of post-Keynesian economics, which is critical of neoclassical models and their notions of perfect markets and pure competition (e.g. Stockhammer 2004, 2012; Jayadev & Epstein 2007; Orhangazi 2008; Hein & Schoder 2011; Dünhaupt 2012, 2013; Hein & Detzer 2015). The sociological scholarship is much smaller in comparison, and is largely the product of a handful of economic sociologists. Their studies usually take one or more of the indicators associated within financialization as explanatory variables, and show that they are associated with rising levels of GINI coefficient (e.g. Kus 2012; Hyde, Vachon, & Wallace 2018), a decline in the labor-share of income paid by NFCs (e.g. Tomaskovic-Devey & Lin 2013; Alvarez 2015), or increasing dispersion between high-income

earners and average workers (e.g. Flaherty 2015; Hyde 2019).

Existing studies of financialization and income inequality are far less averse than other branches of scholarship to the notion of class and centrality of social conflicts as an explanation of income distribution. In the post-Keynesian approach, the distribution of income does not reflect “pure” market forces, but is viewed as an outcome of political struggles between different social groups, which are as likely to lead to dysfunctional as efficient allocation of resources (Lavoie 2006; Dallery 2009). In sociological studies, income inequality is generally understood as “a result of social relations between sets of actors, in which interaction and its resulting institutions generate greater advantages for some actors than for others” (Tomaskovic-Devey & Lin 2013: 1291).

Although these scholars recognize that it is labor that ends up paying the price for financialization through stagnant wages and increasing job insecurity, workers themselves remain conspicuously absent in their accounts. Rather than the struggle between labor and capital, post-Keynesian suggest that financialization reflects the increasing dominance of a rentier class (e.g. Orhangazi 2008; Hein & Schoder 2011; Stockhammer 2012; Dünhaupt 2012; Hein 2015; Hein & Detzer 2015), while economic sociologists view it as the triumph of shareholders over corporate managers (e.g. Tomaskovic-Devey & Lin 2013; Alvarez 2015; Jung 2015; Lin 2016). As a result, the impact of financialization on income inequality appears at most as an unfortunate side-effect or unexpected consequence, and it remains unclear why or how it led to a decline in the labor-share of income paid to workers.

In contrast to these approaches, the theoretical framework I employ prioritizes the class struggle between labor and capital as central to our understanding of the relationship between financialization and income inequality. This is not meant to deny the potential conflicts between managers and shareholders, or the diverging interests of finance (rentiers) and industry. Rather, I

suggest that these conflicts should be examined from a broader class perspective, and understood in relation to the deeper class antagonism between labor and capital. The class struggle framework deployed in this dissertation retains a Marxist emphasis on private property as the foundation of the class structure of capitalist societies. However, rather than the direct ownership of the means of production, I am more concerned here with ownership over financial assets. More specifically, I suggest that *financialization itself can be understood as the rise of financial assets as a dominant form of capitalist property*.

Existing approaches recognize the centrality of financial assets to the relationship between financialization and income inequality. However, they tend to take this type of property for granted, and one will be hard pressed to find any discussion of the “conditions of possibility” of these peculiar assets, the complex legal infrastructure involved in their exchange, or the social relations that remain hidden behind their contractual form. Answering these questions, as the present dissertation aims to do, can offer important insights into the relationship between financialization and income inequality.

What kind of property are financial assets? How do they differ from other forms of property? What are the sources of the income they provide their owners, and what are the social relations that operate through them? These questions are addressed in Chapter Two of the dissertation, which focuses on corporate stocks and corporate debt, i.e. financial assets that represent money advanced for the purpose of production. Drawing on the circuits of capital described by Marx, the chapter shows that the social relations that operate through these types of financial assets are ultimately based on the social relation of capital. In this sense, the rise of financial assets as a form of property leaves the basic conflict between capital and labor very much intact. However, the analysis also suggests that the growing centrality of financial assets *opens up new strategies*

and courses of action with important implications for class struggle. These new possibilities are closely related to the specific form of financial assets, which derive their value from a contractual claim on future income.

I then turn to focus on the rising levels of corporate debt, which is one of the main indicators of financialization at the firm level. I show that rather than a method to “discipline” corporate managers, as suggested by agency theorists, this practice can be better understood as *a strategy to weaken the bargaining power of workers by committing in advance the future income of the corporation, from which wages are also paid.* In this sense, the substitution of debt for equity allows capital to extend the class struggle into the future by setting in advance the terms of the battle. In fact, as the chapter shows, there is a specialized scholarship within financial economics that documents precisely this use of corporate debt, which it describes as a *negotiation tool* or *bargaining device* that managers can use to deny the wage demands of workers or counter attempts at unionization. What makes this scholarship especially compelling as evidence is its favorable view of such strategic use of corporate debt, which it recommends wholeheartedly.

The financial literature mentioned above provide strong evidence for the use of corporate debt as a negotiation tool. However, these studies hardly explain how this strategy came into being, or how it is related to the historical development of the class struggle. Chapter Three explores these issues by investigating the financialization of the U.S. economy from a class perspective.

Existing approaches view financialization as a response to the economic problems of the 1970s, especially the decline in corporate profitability and rising inflation. I show that these problems themselves were closely related to escalation of class struggle with the decline of the postwar era. Like Krippner (2011), I emphasize the role of the state in enabling and promoting the shift toward finance. However, rather than conceptualizing the state as an authority external to the

struggle between labor and capital, I argue that the state itself serves as an increasingly important terrain of this class struggle, and that state policies reflects the contingent outcomes of these conflicts. From this class perspective, the “war on inflation” waged by the Federal Reserve in the late 1970s and early 1980s appears as a form of class warfare, which was calculated to bring down inflation by breaking the power of organized labor.

Drawing on historical sources, I argue that the restrictive monetary policy adopted by the Federal Reserve should be understood as part of a broader shift in *property relations* that reflect the growing importance of financial assets as a form of property. Property relations, as I use the term here, include not only legally defined property rights, but also accepted norms and practices that are not strictly enforceable by law. Similar to Fligstein (1996), I view property rights as “social relations that define who has claims on the profits of firms” (p. 658). However, I also suggest that these property relations can be viewed as institutionalized forms of class relations, the contingent outcome of past conflicts and struggles.

If Chapter Three provides the historical context necessary to understand how corporate debt became an effective “negotiation tool”, Chapter Four shifts to a more micro-level perspective to investigate how this class strategy was deployed during the period of concession bargaining in the early 1980s. Empirically, the chapter offers an analysis of the use of corporate debt as a negotiation tool within three nonfinancial industries: auto, steel, and airlines. I show that in all three industries, the use of corporate debt as a “negotiation device” emerged first in firms that faced grave financial distress, but it quickly spread to other firms that were in a much better condition and faced no danger of collapse. The diffusion of this practice involved coercive, mimetic, and normative mechanisms (DiMaggio & Powell 1983). Coercive, as firms faced pressures from creditors as well as the policies of the Federal Reserve; mimetic, since this

practice was quickly adopted by other firms in the industry once proved useful; and normative, as it involved the social construction of downsizing (Budros 1997) and bankruptcy (Delaney 1992) as legitimate business strategies. Workers were far from passive throughout this process, and desperately tried to resist these pressures. However, after a decade of struggle and in the face of another recession, many union leaders capitulated to managements' demands with some hope of regaining ground when economic conditions improved. This hope, as we know today, was no more than wishful thinking, as organized labor in the U.S. never recovered from this defeat.

The decision to focus on these specific industries is motivated by two main reasons. The first reason is the importance of these industries and their impact on U.S. labor relations. Both the auto and the steel industries occupy a central position in the U.S. economy, and the collective agreements negotiated by their strong trade unions influence collective bargaining processes in many other American industries. The wage negotiations in the auto industry during the early 1980s set the tone for the first wave of concession bargaining in the manufacturing, while the negotiations in the steel industry were central to the second wave of concessions that followed soon after. In the airline industry, in contrast to the industrial unionism in the auto and steel industries, collective bargaining was always highly fragmented, with various unions representing specialized crafts such as pilots, flight attendants, mechanics, and ticket agents. But perhaps because of this fragmentation, it was in the airline industry that the use of corporate debt as a negotiation tool reached its most extreme form through the use of strategic bankruptcy, and the practices developed by airline managers during the period were quickly adopted in other industries, and were instrumental to the wave of leveraged-buyouts during the decade.

The second reason is related to the differences between these industries. Although auto and steel are both part of the manufacturing sector, the first belongs to consumer goods subsector and the

second to the capital goods subsector. The former manufactures products for end-consumers, while the latter manufactures an input for production. The airline industry is a service-providing industry that is part of the transportation and warehousing sector. The specific problems facing each industry were also quite different. Both the auto and steel industries were facing increased international competition. However, the weakness of the U.S. auto industry was related to the product itself, which was much bigger than the European and Japanese models and consumed much more fuel. Thus, the industry could address these issues by changing its designs and improving certain features in its product. In the steel industry, in contrast, the commodity produced is fungible, and there was little difference between the good provided by American and foreign firm. Here the problem was simply over-capacity, as new European and Japanese producers enter the market while the general demand for steel was declining due to the increasing use of alternative materials such as aluminum. The airline industry, of course, is very different from both the auto and steel industries, and belongs to the service sector rather than manufacturing. Its product is highly perishable, since unfilled seat cannot be stored for future sale, and it is far more sensitive to business cycles, especially with respect to pleasure travel. More important in the present context, U.S. airlines faced no foreign competition during the period under review, and its problems were related to the deregulation of air transportation in the late 1970s, which allowed every carrier to compete in every route and led to cut-throat competition that ended in multiple bankruptcies. Thus, here globalization and the labor costs of foreign competitors cannot explain the negative outcome for workers, as can be argued with respect to the auto and steel industries. Despite these and other differences, in all three industries the spread of concession bargaining followed a similar pattern, which is explained by focusing on the use of corporate debt as a negotiation tool, as this dissertation aims to show.

Methods and data sources

The methodology employed in this dissertation can be described as a *historically-grounded class analysis*. This methodology is in line with much of the “new historical sociology”, which emphasizes the importance of temporality, sequence, and contingency in explanations of long-term social processes (Aminzade 1992; Griffin 1993; Gotham & Staples 1996; Somers 1996). Unlike comparative historical sociology, which evaluates and contrasts several cases in a way that helps isolate specific casual variables, more recent approaches focus more on constructing an analytical narrative, understood as “theoretically structured stories about coherent sequences of motivated actions” (Aminzade 1992: 458). The explanatory power of narratives lies in its ability to “unify a number of past or contemporaneous actions and happenings, which might otherwise have been viewed as discrete or disparate, into a coherent relational whole” (Griffin 1993: 1097).

The use of narrative is the traditional mode of writing for historians. What makes this dissertation a sociological rather than a historical work is the theoretical framework used to structure the historical “raw data” into a meaningful narrative. As Sewell (2005) observes, while historians tend to opt for multiple causality and detailed circumstantial narrative, social scientists prefer explanations that are based on “a relatively limited set of enduring, entrenched, and causally powerful features of the social world” (p. 14). In the present dissertation, these features are inscribed in the class struggle framework elaborated above. This framework serves as, to borrow Sewell’s phrase, a specific “logic of history” through which I examine the relationship between financialization and income inequality. To be sure, class struggle is not the only possible “logic” through which to examine these developments, and the events and processes reviewed in the following chapters can be arranged into different narratives according to the

specific goals of the researcher. However, if we consider income inequality as “a result of social relations between sets of actors, in which interaction and its resulting institutions generate greater advantages for some actors” (Tomaskovic-Devey & Lin 2013: 1291), then this specific “logic” can provide valuable insights into its relationship with financialization.

The “raw materials” used to construct the narrative presented in the empirical chapters include both quantitative and qualitative data drawn from a variety of sources. Macroeconomic data on the U.S. economy is obtained from statistics published by the Federal Reserve, the U.S. Bureau of Economic Analysis, and the U.S. Bureau of Labor Statistics. Financial data on specific sectors and industries is drawn from the *Corporation Income Tax Returns Report* published by the Internal Revenue Service (IRS), the *Quarterly Financial Report for Manufacturing Corporations* published by the Federal Trade Commission (FTC), the *Air Carrier Financial Statistics* published by the Civil Aeronautics Board, the *Air Transport Report* published annually by Air Transport Association, the *Annual Survey Concerning Competitive Conditions in the Steel Industry* published in 1985-1989 by the U.S. International Trade Commission, as well as other congressional reports and documents published by various governmental agencies.

Primary sources used in the dissertation include transcripts from congressional hearings, transcribed speeches and addresses of Chairmen of the Federal Reserve (Arthur Burns and Paul Volcker), and documents and statements submitted to the U.S. Congress. Chapter Four also relies heavily on reports from business and financial newspapers during the period which provide a rich source for economic data, first-hand accounts from union officials and corporate managers, and commentary by financial journalists.

Contributions

The dissertation offers several distinct contributions to the literature on financialization and

income inequality. Empirically, it identifies the strategic use of corporate debt as a specific channel through which financialization contributes to income inequality. Chapter Two finds evidence for such a causal connection in a specific strand within financial economics that documents the use of corporate debt as a “negotiation tool” to extract wage concessions from workers and undermine the bargaining position of trade unions (e.g. Bronars & Deere 1991; Perotti & Spier 1993; Hanke 1998; Klasa, Maxwell, & Ortiz-Molina, 2009; Matsa, 2010; Simintzi, Vig, & Volpin 2015; Woods, Keng-Tan, & Faff 2019). Chapter Three traces the historical conditions which enabled this strategy to the development of the class struggle in the U.S. economy during the 1970s, and the related shift in property relations that accompanies the growing importance of financial assets as a form of property. Chapter Four shows how this strategic use of debt spread during the period of concession bargaining in the early 1980s, focusing on three key nonfinancial industries. By going beyond statistical analysis to examine the actual conflicts through which this strategy took shape, the dissertation gives labor a voice that is largely absent from the existing literature. Instead of relating the impact of financialization on income inequality to the unilateral decisions of managers or shareholders, it shows that workers and their unions fought hard against these actions but lost. The impact of financialization on income inequality, therefore, should be viewed as the contingent outcome of this class struggle, rather than an inherent property of finance in itself.

Theoretically, the research challenges existing accounts that trace the impact of financialization on income inequality to the rise of the Shareholder Value (SV) approach to corporate governance (e.g. Fligstein & Shin 2007; Tomaskovic-Devey & Lin 2013; Alvarez 2015; Jung 2015), and the growing power of a rentier class (e.g. Epstein & Power 2003; Stockhammer 2004; Jayadev & Epstein 2007; Dallery 2009; Dünhaupt 2012, 2013; Hein & Detzer 2015). Instead, it outlines a

class struggle framework that can better explain the impact of financialization on income inequality. The main innovation of this framework lies in its emphasis on financial assets as a form of property, as opposed to the direct control of the means of production. The theoretical analysis provided in Chapter Two suggest that although the growing importance of financial assets leaves the basic conflict between labor and capital very much the same, it opens up new strategies within the class struggle, which are related to the specific form of financial property. The dissertation also develops the notion of property relations as a useful way to connect the economic processes associated with financialization to the social relations that underlie this shift.

Chapter 2. Property and the Social Relations of Finance

Introduction

The emerging literature on financialization and income inequality is divided between two sub-disciplines: one in economics and one in sociology. The lions-share of the research is produced by post-Keynesian economists, who adopt a macro-level perspective and focus mainly on the impact of financialization on the distribution of national incomes (e.g. Epstein & Power 2003; Stockhammer 2004; Jayadev & Epstein 2007; Orhangazi 2008; Hein & Schoder 2011; Dünhaupt 2012; Hein & Detzer 2015). A second, much smaller group, includes contributions from economic sociologists, who are more concerned with the financialization of nonfinancial corporations (NFCs) and its impact on the distribution of income within the firm (e.g. Tomaskovic-Devey & Lin 2013; Alvarez 2015; Jung 2015; Lin 2016).

Both groups of scholars provide convincing evidence of a strong statistical association between indicators of financialization and measures of income inequality, and conclude that the rise of finance has undermined the power of labor and trade unions. However, their explanations of this relationship tend to rely on existing accounts of financialization that pay little attention to workers themselves. As a result, the impact of financialization on income inequality appears at most as an unintended consequence or unfortunate side-effect, and it remains unclear why it led to this result, or where workers were when all of this was taking place.

Nevertheless, existing studies offer a useful path forward by emphasizing the growth of financial income from interest and dividends as central to the link between financialization and income inequality. Since this financial income flows to the owners of financial assets in the form of stocks, bonds, loans, and other financial instruments, scholars suggest that the age of financialization “was one in which financial asset holders became increasingly powerful in their

claims on the income of the non-financial sector” (Tomaskovic-Devey, Lin, & Meyers 2015: 16), and that finance itself should be viewed as “a weapon by which the claims of wealth holders are asserted against the rest of society” (Jayadev, Mason, & Schröder 2018: 354). These assertions point to the growing importance of ownership over financial assets. However, they tell us very little about this specific form of property, the sources of the money flowing to its owners, or the social relations that underlie these streams of income.

These questions are addressed in the present chapter. The following section reviews the existing literature on financialization and income inequality. I then turn to a theoretical analysis of financial assets, focusing specifically on corporate stocks and corporate debt, i.e. financial assets that arise from money advanced for the purpose of production. The analysis draws on the circuits of capital described by Marx with the goal of linking these financial assets to the relations of production of the capitalist economy.

Beyond shareholders and rentiers

Most of the emerging literature on financialization and income inequality is located within the heterodox school of post-Keynesian economics, which is critical of neoclassical economics and its notions of perfect markets, pure competition and substantive rationality (Lavoie 2006). In contrast to the neoclassical orthodoxy, post-Keynesian theories are historically and institutionally specific. In post-Keynesian models, the distribution of income is not viewed as a result of “market forces” or economic efficiency, but the outcome of political struggles between different social groups and classes.

At the center of financialization, post-Keynesians locate the figure of the *rentier*, generally understood as “wealthy people who get most of their incomes from owning financial assets, rather than working or from owning productive assets” (Epstein & Power 2003: 3). Post-

Keynesian studies of financialization and income inequality focus on the notion of *rentiers' income*, alternatively defined as the share of interest and dividends in the national income (e.g. Stockhammer 2004; Orhangazi 2008; Hein & Schoder 2011; Hein 2015), total interest payments plus profits of financial institutions as a share of GDP (e.g. Epstein & Power 2003; Jayadev & Epstein 2007; Palley 2008), or net property income of households as a share of the national income (e.g. Dühaupt 2012; Hein & Detzer 2015). Their empirical studies show that the advance of financialization is associated with an increase in rentiers' income in many developed economies. Post-Keynesians conclude that financialization corresponds to the growing power of a *rentier class*, which was able to appropriate an increasing share of the national income.

Post-Keynesians provide valuable insights into the macro-economics of financialization. They show that the rise of finance is associated with a slower rate of capital accumulation (Stockhammer 2004; van Treeck 2007; Hein 2012) and weaker aggregated demand (Stockhammer 2007; Hein & van Treeck 2008; Palley 2008; Onaran, Stockhammer, & Grafl 2011; Hein 2015). These contribute to a decline in the rate of growth, which leads to wage stagnation and rising income inequality across advanced economies. However, their models are mainly geared toward economic analysis, and offer a thin conception of class or the social relations that underlie the shift toward finance.

The figure of the exploitive *rentier* is drawn directly from Keynes (2013), who employed a three-class model of society, which included an investing class (rentiers), a business class (entrepreneurs), and an earning class (workers). Whether or not this model actually corresponded to “a social cleavage and an actual divergence of interest” (Keynes 1924: 5) in the early twentieth century, the growing dominance of large corporations in the second half of the century has made it much less relevant. This problem is reflected in the difficulty of deciding who should

be considered a rentier. Some post-Keynesians exclude the shareholders of NFCs, who are viewed as akin to the industrial capitalists of the nineteenth century (e.g. Epstein & Power 2003; Jayadev & Epstein 2007), while others include all corporate shareholders within the rentier class, and regard corporate managers as the modern incarnation of the industrial capitalist (e.g. Stockhammer 2004; Dallery 2009; Dünhaupt 2012, 2013; Hein & Detzer 2015). Even if we accept the social account presented by Post-Keynesian economists, their macro-level perspective makes it is hard to identify specific channels and mechanisms through which rentiers were able to shift the distribution of income in their favor.

In contrast to the post-Keynesian approach, economic sociologists studies are generally more concerned with the financialization of the firm and its impact on the distribution of income within NFCs (e.g. Tomaskovic-Devey & Lin 2013; Alvarez 2015; Jung 2015; Lin 2016). Their analyses show that key indicators of financialization at the firm-level - including growing reliance on finance-based income, a shift of investments from productive to financial assets, and higher distribution of dividends - are strongly associated with a decline in the labor-share of corporate income paid to workers (e.g. Tomaskovic-Devey & Lin 2013; Alvarez 2015; Tomaskovic-Devey, Lin, & Meyers 2015), an increased wage gap between average workers and top managers (e.g. Tomaskovic-Devey & Lin 2013; Flaherty 2015) and more frequent layoffs and downsizing (e.g. Jung 2015; Lin 2016). To explain these results, economic sociologists point to the wide adoption of the Shareholder Value (SV) approach to corporate governance, in which the sole responsibility of corporate managers is to maximize the returns to their shareholders (e.g. Fligstein 1993; Lazonick & O'Sullivan 2000; Fligstein & Shin 2007). According to this approach, financialization reflects the growing power of corporate shareholders, who were able to align the incentives to managers with their own interests (e.g. Fligstein 1993; Dobbin & Zorn

2005; Shin 2013; Heilbron, Verheul, & Quak 2014). Economic sociologists conclude that “financialization... restructured the social relations between owners and workers, elite and general workers, and employees in general, thus reshaping the relative power of actors along these divides” (Tomaskovic-Devey & Lin 2013: 1291).

The focus on the firm-level provides a better vantage point from which to examine the relationship between financialization and income inequality. It allows economic sociologists to distinguish between specific processes associated with financialization and examine their independent impact through carefully designed statistical tests. From this firm-level perspective, sociologists are able to offer a more nuanced account, which suggests that financialization contributes to income inequality through its impact on the balance of power between different stakeholders in the corporation itself. Nevertheless, the firm-level focus also raises important difficulties. While it is certainly possible to identify the shareholders of a specific corporation, it is much less clear who should be included in this group when we move to a macro-social perspective. Everyone who own stocks, regardless their amount or total value? Only active shareholders with a substantial stake in the firm? What about institutional investors such as pension funds and insurance companies, which were central advocates of the SV approach?

The emphasis on conflict between managers and shareholders also seems somewhat misplaced. While the focus on such conflicts can be useful when analyzing the organizational dynamics within a specific corporation or even an industry, it becomes less tenable when we move to examine society as a whole. The idea that managers and shareholders are two distinct social groups on-par with the working class is hardly convincing. Even at the height of “managerial capitalism”, Mills (1956) noted that chief executives and their wealthy shareholders “are both very much mixed up in the corporate world of property and privilege” (p. 119); Baran and

Sweezy (1966) also insisted that “the managerial stratum is the most active and influential part of the propertied class” (p. 34; see also Zeitlin 1974; Useem 1984). Corporate executives are usually among the largest shareholders in the corporations they manage, and hold a substantial stake in other corporations as well. What appears as a conflict between managers and shareholders is more often than not a battle between competing groups of shareholders, each holding a substantive stake in the corporation, although far from a majority control.

Even if corporate managers could be considered a distinct social group with its own specific interests, it is unclear how they would be able to reproduce this dominant position against the will of their shareholders. Managerial positions are not hereditary, and without the support of some shareholders at least, no CEO is likely to stay on the job for very long. Scholars who emphasize the importance of the SV approach also recognize that this model of corporate governance was very beneficial to corporate managers, who saw their compensation packages skyrocket (Dobbin & Jung 2010; Lazonick 2014). This trend seems inconsistent with the idea of declining managerial power or the subordination of managers to the interests of shareholders. It is hard to explain how the weakness of corporate managers made them wealthier than ever.

Post-Keynesians and economic sociologists are certainly right to emphasize the growth of financial income as central to the link between financialization and income inequality. However, this type of income is not exclusive to any distinct social group or class, not in the same way that ground rent was once the exclusive income of the nobility. What the recipients of financial income have in common is not a specific occupation or pedigree, but ownership of a specific type of property in the form of financial assets. In other words, financial income is essentially property-based income. From this perspective, financialization itself can be usefully understood as *the rise of financial assets as a dominant form of capitalist property*. The owners of this form

of property are not a distinct social group or even a clearly identifiable faction within the capitalist class. Rather, financial assets are generally concentrated in the hands of wealthiest segments of society, and have become even more unevenly distributed with the advance of financialization. Saez and Zucman (2016), for example, calculate that the top 1 percentile of U.S. households held about 20 percent of corporate stocks in the late 1970s, compared with more than 30 percent in 2012, while their share of interest-bearing assets (fixed claim) rose from 25 percent to more than 36 percent during the same period. Other studies and reports show a similar trend (e.g. Congressional Budget Office 2016; Kuhn, Schularick, & Steins 2017; Wolff 2017).

In short, while both post-Keynesians and economic sociologists note the growing importance of financial assets as a form of property, I argue that this development does not indicate the rise of a new dominant class, but a transformation in the way income is appropriated by the capitalist class as a whole. To understand how and why this development undermines the power of labor, it is necessary to examine more closely the social relations that operate through this type of property.

The social relations of corporate finance

To understand the social relations that operate through financial assets, it is essential to identify the sources of the income flowing to their owners. This is not as simple as one might think, as the term “financial assets” is actually a broad label that covers a wide variety of instruments, including certificates of bank deposits, corporate shares, government bonds, commercial paper and more. Different types of financial assets are tied to different sources of income, which also suggests that they correspond to different social relations. Things are even more complicated when we consider that the two sides to these financial contracts are often collective actors such as corporations, governments, and organizations. Does corporate equity reflect a relation

between shareholders and the corporation as a whole, or only with its top managers? Where do workers figure into this relationship?

Despite their dazzling diversity, all financial assets originate from sums of money that are advanced from one party to another against the promise of future monetary payment. Given this common origin, it is possible to classify financial assets according to the sector to which money is advanced. From a macro-economic perspective, these include households (e.g. consumer credit, mortgages), businesses (e.g. equity, bonds, loans), and governments (e.g. bonds, treasury bills). In what follows, I focus on financial assets that originate from sums of money advanced to the business sector, and specifically credit extended to the corporate sector on the basis of equity (stocks) or debt (bank loans and debt securities). It is clear that if financialization contributes to rising income inequality, it has done so through its impact on the distribution of income within NFCs, and not because households pay a larger share of their disposable income to financial institutions. In other words, I am mainly concerned with the issue of corporate finance and the income paid by NFCs in the form of interest or dividends.

To examine the social relations that operate through corporate finance, it will be useful to begin with the social relation of capital, for two main reasons. First, the analysis of the social relations of capital is more familiar, and helps introduce the general framework used for investigating the social relations of these financial assets. Second, the social relations that operate through corporate stocks and debt are intertwined with broader capitalist relations of production, and in a sense presuppose their existence. Even financial transactions that are not directly related to production, for example the provision of consumer credit or residential mortgages, take place under capitalist conditions and must be examined in relation to the system as a whole. At the very least, the need for such credit is tied to the level of wages and household disposable income,

as recent decades have shown (Crouch 2009; Krippner 2011; Streeck 2011; Kus 2015).

Property, of course, is always already a social relation, since the property rights of any individual or social group are necessarily also an exclusion of others from the same rights (e.g. Singer 2000; Cole & Grossman 2002). Capital is also form of property, and as such also include a relation of exclusion - the exclusion of workers from the means of production. However, capital also involves another social relation for which exclusion is a necessary yet insufficient condition. This is a relation of exchange, and specifically exchange with wage-labor. It is only by coming into contact with wage-labor that a thing can become capital. This relation is implicit even in mainstream economics, which defines capital as buildings, machines, and other durable assets that are “produced in order to produce yet other goods” (Samuelson & Nordhaus 2010: 9). Since such objects do not engage in production by themselves, someone must put them into use.

Capital, as a distinct economic category, only emerges with the separation of workers from the means of production. Even in England, this historical process was still not much advanced in the early eighteenth-century, before “wholesale enclosure” eliminated villages’ common rights for good (Thompson 1966: 198). In the mid-seventeenth century, the English economist William Petty ([1662] 1769) still had no concept of capital, and insisted that “hands were the father as lands were the mother of wealth” (p. 68). A hundred years later, the French economist Anne-Robert-Jacques Turgot ([1766] 2011) knew to explain that capital emerges when a person “receives each year more value than he needs to spend”, and therefore “may set aside this surplus... these accumulated values are what is called a capital” (p. 34). A decade after Turgot, Adam Smith ([1776] 1977) wrote that the “stock” of any person can be divided into two: one part supplies immediate consumption, while the other “which, he expects, is to afford him this revenue, is called his capital” (p. 363).

For Marx, capital does not exist as an innate object, but only comes into being through and within the process of production. Through this process, capital expends itself by generating profits that are reinvested as new capital. In this way, “the value originally advanced... not only remains intact while in circulation, but increases its magnitude... and this movement converts it into capital” (Marx 1981: 252). For Marx, this self-expanding property is founded on the exploitation of workers and the extraction of surplus value from unpaid labor.

Marx provides a visual representation of this process in his circuits of capital model (Cleaver 2016). Here we find money (M) as the starting point of the cycle. This money is turned into commodities (C), which are then turned back into a greater sum of money (M’):

$$M \rightarrow C \rightarrow M'$$

This cycle is characteristic of merchant capital, where profits arise from the difference between the buying and selling price. Each step of this process represents a transformation in the form of capital. At the start we have money-capital, which is transformed into commodity-capital, and back to money-capital which has greater value than the original money capital ($M < M'$). With industrial capital, we get an extended circuit that includes the exchange of money-capital for labor power (LP) and means of production (MP). These enter into the process of production (P), from which emerges a new commodity, with a value greater than the commodities that enter into the production ($LP + MP < C'$). This value is realized through the sale of the commodity, which transform it back into money:

$$M \rightarrow C \overset{MP}{\underset{LP}{\dots}} P \dots C' \rightarrow M'$$

For Marx, money-capital (M), productive capital (LP+MP) and commodity-capital (C’) are only different moments of the same process, or distinct forms of the same capital. “The capital that assumes these forms in the course of its total circuit... is industrial capital - industrial here in the

sense that it encompasses every branch of production” (Marx 1992: 133).

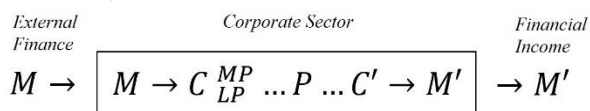
In the figure above, money-capital is the starting point of the circuit, and it is assumed that it is in the hands of the producer from the very start. However, in the third volume of Capital Marx incorporates the provision of credit by adding two steps to the cycle: one in the beginning and one in the end. The starting point now is the lender who advances the money to the producer. The lender is also the ending point, as the money originally advanced is paid back with interest:

$$M \rightarrow M \rightarrow C \overset{MP}{\underset{LP}{\dots}} P \dots C' \rightarrow M' \rightarrow M'$$

As the figure shows, the monetary return to the lender is paid out of profits from production. Although the money advanced as capital must pass through the process of production to increase its value, from the point of view of the lender, the process appears in a shorthand form as $M \rightarrow M'$, i.e. money exchanged for more money. This gives the impression that it is a natural property of money to create value and yield interest, “as it is the property of a pear tree to bear pears” (Marx 1991: 516).

In social terms, Marx viewed the owner of money as a *money capitalist*, and the borrower as a *functioning capitalist* that organizes and controls the production process. These figures represent consecutive stages in the circuit of capital, with the functioning capitalist serving as the owner of the productive capital, which includes the means of production and labor power. Although the money capitalist does not confront wage-labor directly, he nevertheless “participates in the exploitation of labour as represented by the functioning capitalist” (Marx 1991: 504). This picture changes with the rise of the modern corporation, which transferred the control of the production process to hired managers, while transforming the functioning capitalist into a shareholder who has more in common with the money capitalist than with the small business owner. Rather than consecutive stages, here we find both owners (shareholders) and creditors

(debtholders) as providing different types of external finance, while hired managers take the role of the functioning capitalist:



The initial M can be money advanced as debt or equity, while the final M' can represent either interest or dividends, yet in both cases money flows out of the corporation. Interest is a deduction from the operating profit of the corporation, i.e. profit from ongoing core business operations before interest expenses and taxes. Dividends are distributed out of net profit. However, the ultimate source of both is value generated in the process of production.

The rise of the modern corporation also means that productive capital - once the property of an individual owner – now becomes the property of the corporation itself. Marx (1991) regarded this development as “the abolition of capital as private property within the confines of the capitalist mode of production itself” (p. 567). This process, which was only incipient in the late nineteenth century, has become the general rule during the twentieth century. Through this process, the modern corporation has effectively “socialized property... not within the institutional structure of publicly accountable government, but within the institutional structure of corporate capitalism” (Roy 1997: 266).

The socialization of capital under the corporate form blurs the distinction between the owners of the enterprise and its lenders. This aspect did not escape perceptive observers early in the twentieth century. Veblen (1904), for example, explained that the modern industrial economy utilizes two forms of credit: “the old-fashioned loan, the usage of which has come down from an earlier day, and the stock share, whereby funds are invested in a joint stock company or corporation” (p. 114). Watkins (1907) adds that while stockholders are “in effect” creditors,

bondholders sometimes provide the initial capital for the enterprise.

Since both interest and dividends are paid out of corporate profits, there appears to be a conflict between shareholders and debtholders: other things being equal, higher interest payments mean lower net profit, from which dividends are distributed. However, issuing debt allows the corporation to expand production and increase its profit, as long as the interest rate is lower than the rate of profit. If a corporation borrows money at a 5 percent interest rate, which it uses for production that provides a profit rate of 10 percent, it can pocket that 5 percent difference without committing any capital itself. This common practice is called “leveraging”, and the ratio between the debt and equity as sources of external finance is considered a “leverage ratio”.¹ Once leverage is taken into consideration, “it becomes clear that access to loanable money capital can directly affect the profitability of the functioning capitalist” (Lapavistas 2014: 154).

The main conclusion I wish to draw here is that the social relation that operates through corporate finance, whether in the form of equity or debt, is ultimately based on the social relation of capital, i.e. the relation between capital and wage-labor. The income these assets command presupposes the existence of income generated in production, from which interest and dividends are paid. The relation between these financial payments and labor is indirect, mediated through the corporate form. Here we find managers oppose workers as representatives of capital in general, a role Marx assigns to the functioning capitalist, who has become a shareholder removed from an active role in production. The division of corporate profits between interest and dividends, which depends on the level of financial leverage, is secondary to the division between wages and profit. In this sense, the focus on a conflict between managers and shareholders, or

¹ Debt-to-Equity ratio is one of the most common measures for leverage, but it is not the only one. Alternative measures include the ratio of debt to total assets or the ratio of debt to EBIDTA (earnings before interest, tax, depreciation and amortization).

between rentiers and industry for that matter, mistakes a functional division of income for a social relation between distinct groups or classes, since “what appears as an antagonism in terms of the division of profit corresponds to the functional difference between productive capital and money-capital” (Brunhoff 1976: 90). Rather than the rise of a new dominant class, the growth of financial income reflects a transformation in the form of property itself, or the rise of financial assets as a dominant form of capitalist property.

This development, to be sure, leaves the basic conflict between capital and labor very much intact. However, *it opens new strategies and courses of action within this ongoing class struggle*. These strategies are related to the specific form of financial assets, which represent a contractual claim on future income rather than the value contained in existing assets. To understand how financial assets give rise to novel class strategies, it is necessary to examine more closely the specific form of this type of property.

Financial assets as a form of property

Financial assets are basically contractual obligations between two sides, or “monetary claims by one party against another party” (Samuelson & Nordhaus 2010: 284). The value of these assets is not to be found in their physical form, but is derived from the promise of future payment they represent. This aspect is clearly reflected in the valuation of financial securities, which are defined as *tradeable* financial assets. As one expert on financial valuation explains, investors are not interested in the aesthetic or emotional value of securities but in the return they expect to receive, “which implies that the price we pay for any asset should reflect the cashflows it is expected to generate” (Damodaran 1994: 1).

Financial assets are much more *liquid* than other forms of property, which means that they can be quickly converted into cash by selling them on financial markets or over-the-counter. However,

the liquidity of financial assets does not indicate “a transcendence of the particular physical forms of different bits of capital”, or that “the physical differences between railroads and knitting mills... [are] transcended by the share market” (Bryan, Martin, & Rafferty 2009: 466). What becomes liquid with financial assets is not capital itself, but a contractual claim on the profits produced with capital. Although corporate stocks and corporate debt presuppose its existence, they are no more this capital than a mortgage on a house is the house itself. As Marx (1991) also notes, capital “does not exist twice over, once as the capital value of the ownership titles, the shares, and then again as the capital actually invested... It exists only in the latter form, and the share is nothing but an ownership title... to the surplus-value which this capital is to realize” (p. 597). In this sense, Hilferding (1981) is right to point out that “the customary description of the stock exchange as the ‘capital market’ misses the essential nature of that institution” (p. 131). Rather than capital, the stock exchange mobilizes claims on future income, which increasingly displaces capital - now owned by the corporation itself - as a dominant form of property.

The liquidity of financial assets, which can be quickly converted back into cash, clearly distinguishes the modern investor from the nineteenth century money-capitalist described by Marx. Unlike the money-capitalist, who had to advance money for a fixed period and could not recover it before it passed through the process of production, shareholders and bondholders can quickly withdraw their money by selling the stocks and bonds they own in response to any strike threats or the slightest sign of labor militancy. Indeed, economic studies find a statistical relationship between strikes and labor disputes and a decline in stock prices as a result of such tendencies (e.g. Neumann 1980; Ruback & Zimmerman 1984; Becker & Olson 1986; Abowd 1989; Nelson, Amoako-Adu, & Smith 1994; Dinardo & Hallock 2002). In a similar way, wage concessions and approval of “right-to-work” laws, which limit collective bargaining, are shown

to have a positive impact on stock prices (Becker 1987; Thomas, Officer, & Johnson 1995; Abraham & Voos 2000).

More evidence of a relation between strikes and stock prices can be found in financial journals, and this is perhaps the main context in which these journals report on labor-related issues.² The reason is stated quite clearly in *Barron's*, a weekly newspaper published by Dow Jones & Company. In a recent article titled “What Rising Labor Militancy Means for Investors”, the author explains that:

*Companies divide the value they create among creditors, shareholders, managers, and workers. The precise split depends on each group's relative power. In the early 1980s, for example, creditors to U.S. corporations got paid almost as much in interest as shareholders earned in after-tax profits. Nowadays, shareholders earn about five times as much as creditors. Both types of investors have done far better than the typical worker.*³

The topic of the article is the upsurge in strikes in 2018. Its conclusions are meant to reassure nervous investors by stating that despite the record number of Americans participating in large strikes, “labor militancy has been on a relentless decline since the early 1970s - and a close reading of the latest figures shows no indication this is changing”. To suggest that labor “militancy” is associated with a decline in stock prices also implies that labor complacency might be associated with rising stock prices. It seems an unlikely coincidence that the growing

² Some recent examples: Owusu, T. (31 May 2018), *Casino stocks fall as union strike deadline approaches*, TheStreet. Retrieved from: <https://www.thestreet.com/investing/stocks/casino-stocks-tumble-as-union-strike-deadline-approaches-14607224>; Riley, C. (1 October 2018), *Ryanair's strikes are hitting its profits and stock price*, CNN. Retrieved from: <https://www.cnn.com/2018/10/01/investing/ryanair-profit-warning/index.html>; Meijer, B. H., & Kar-Gupta, S. (17 August 2018), *Air France-KLM shares fall, Dutch pilots threaten to strike*, Reuters. Retrieved from: <https://www.reuters.com/article/us-air-france-klm-ceo/air-france-klm-shares-fall-dutch-pilots-threaten-to-strike-idUSKBN1L211I>

³ Klein, M. C. (13 February 2019). *What rising labor militancy means for investors*. Barron's. Retrieved from: <https://www.barrons.com/articles/rising-labor-militancy-threatens-municipal-bonds-more-than-stocks-51550076440>

centrality of stock markets in the U.S. coincides with a “relentless decline” of organized labor. The dispersion of stock ownership, which give rise to the potential conflict between managers and shareholders, also contributes to the liquidity of these financial assets. This dispersed stock ownership should not be confused for a wider social distribution of wealth. Dispersion refers to the number of shareholders within a single corporation, not the distribution of stocks across society as a whole. However, dispersed ownership does mean that shareholders are less exposed to the risks associated with any one corporation, since they hold a diversified portfolio which includes stocks in various firms (Peress 2010). An investor who owns 50 percent of a large auto manufacturer will face a major problem if it declares bankruptcy compared with an investor who holds only 5 percent in the same firm and a similar stake in 9 other manufacturers. By the same token, the dispersion of stock ownership also contributes to undermining the power of organized labor. If the main threat of unionized workers is the economic damage they can inflict, this weapon is much less effective when each shareholder has a very small stake in the corporation. Thus, the dispersion of stock ownership increases the resilience of the capitalist class as a whole. While it might limit the power of shareholders within a specific corporation, it actually increases their collective class power. From this perspective, it is easier to explain the “paradoxical situation in which business appeared to lack any kind of unifying institution... while at the same time its power seemed virtually unchallenged” (Mizuchi 2004: 28). The unifying institution is precisely the institution of financial property, or more concretely, the stock exchange where this type of property is bought and sold.

Minimizing the risk of labor militancy through dispersed stock ownership and the ability to sell the stocks and bonds of firms facing possible strikes are two examples of the strategies enabled by the rise of financial assets as a dominant form of capitalist property. I refer to them as *class*

strategies not because they are the result of a collective decision by the capitalist class as a whole, but because they overlap with the class lines that divide society, and in this sense emanate from the structure of the capitalist economy itself. These strategies can be explained at the individual level, as a rational behavior of corporate managers, shareholders, and creditors, but this rationality itself is conditioned by the existing relations of production, and reflects a specific standpoint within the social structure. In this sense, the SV approach itself can be understood menu of such strategies. Officially intended to “maximize” the value for investors, this model of corporate governance is not concerned with increasing the revenues of the corporation or improving its productivity. Its prescriptions have nothing to do with the creation of “new” value, only with the distribution of value already produced by the corporation.

Does this mean that financialization necessarily undermines the power of organized labor, as existing studies suggest? Not necessarily. In fact, some post-Keynesians show that in countries with high union membership, a smaller share of the national income is paid as interest and dividends (e.g. Jayadev & Epstein 2007), while sociologists argue that the impact of financialization on income inequality is weaker in countries with higher union density (Kus 2012). Thus, it is also possible that the decline in the power of labor was more of a necessary condition than an outcome of financialization.

It is possible to move beyond the question of causality if we consider that the quantitative relationship between economic categories such as profit and wages hides behind it a social relation between people, and as such it is never fixed once and for all, but changes with the development of these relations themselves. From this perspective, the growing importance of financial assets is neither a cause nor an outcome of the declining power of labor, but an element within the historical development of this class struggle. Here I join Joseph (2014) in suggesting

that financialization itself can be understood as “the extension and intensification of the social relations entailed by the creation, exchange, and management of financial instruments” (p. 2).

As suggested above, the SV approach to corporate governance can be understood as a set of strategies and practices within the ongoing class struggle between labor and capital. The empirical chapters of my dissertation focus on one such strategy: the use of corporate debt as a “negotiation tool” within collective bargaining processes. This strategy is related to the substitution of debt for equity as a source of external finance, which is one of the main recommendations of the SV approach. In the following section I take a closer look at this practice, and reinterpret it in light of the analysis provided above.

Corporate debt as a negotiation tool

In 1986, the financial economist Michael Jensen published an article on the agency costs of *free cash flow* (FCF), i.e. the cash left after deducting operating expenses and capital expenditures from corporate revenues. Jensen argued that since managers are under no legal obligation to distribute dividends to their shareholders, they are more likely to use available cash flow for sub-optimal investments or waste it on various corporate inefficiencies rather than returning money to their investors. Jensen suggested that it is possible to overcome this problem by issuing more debt and using the proceeds to distribute dividends or stock buybacks. In this way, managers can give shareholders “the right to take the firm into bankruptcy court if they do not maintain their promise to make the interest and principle payments” (Jensen 1986: 324).

A decade earlier, Jensen and fellow economist William Meckling co-authored the influential article “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure” (1976), which provided the foundation for their *agency theory*. The article, which focused on the principal–agent problem in the context of corporate governance, suggested the concept of *agency*

costs to discuss the expense borne by a "principal" (shareholder) when hiring an "agent" (manager) to act on its behalf. While the 1976 article emphasized the agency costs associated with corporate debt, the 1986 article considered how corporate debt can also be used to reduce the agency costs associated with FCF.

Jensen's 1986 article is often referenced by scholars of financialization in connection with the strategy of substituting debt for equity as a source of external finance (e.g. Lazonick 2012; Batt & Appelbaum 2013; Epstein 2015; Tomaskovic-Devey, Lin, & Meyers 2015; Davis 2017). However, its main proposition - that corporate debt can be used to "discipline" managers - is somewhat perplexing. For one thing, decisions regarding debt are generally the prerogative of management, and it is unclear why would managers use it to limit their own discretion in advance. And even if shareholders could somehow force managers to "bond their promise to pay" (Jensen 1986: 324), one must wonder why not simply use their power to force managers to distribute a dividend when these profits actually materialize. In fact, since corporations always rely on a mixture of debt and equity, shareholders hardly need managers to substitute debt for equity: they can simply sell some stocks and buy corporate bonds instead.

More importantly, FCF itself is not a discrete sum of money available for spending at the discretion of managers. Rather, it is a balancing item that is calculated by taking the total cashflow of the corporation and subtracting expenses related to its operations and capital investments. In other words, FCF is simply a different way of looking at the distribution of corporate income. Thus, to talk about the distribution of future FCF is to talk about the distribution of future income, a distribution that has not yet taken place. As an accounting construct, FCF is mainly used as a measure of the funds available for distribution to security holders (Brealey, Myers, & Allen 2016). However, managers and shareholders alike can never

know in advance what the available FCF will be in the next year, or even in the next quarter, as it depends on the future revenues and expenses related to the operation of the business.

If the substitution of debt for equity is not likely to discipline managers, how can we explain the growing reliance on corporate debt as a source of external finance? This question can be posed differently: if the substitution of debt for equity indeed strengthens the claim of security holders over the future income of the corporation, whose claim becomes weaker as a result?

The answer, as the present research aims to show, is labor. Rather than a tool to “discipline” managers, *the substitution of debt for equity can be better understood as a strategy to weaken the bargaining power of workers, who rely on this future cash flow as a source for their income and a basis for potential wage increases*. In this sense, to commit in advance a share of this income to shareholders or bondholders is to extend the class struggle into the future.

Agency theory represents one approach within the broader economic literature on *capital structure*, i.e. the specific combination of sources a firm can employ to finance its operations, which include internal sources (retained earnings) and external finance (debt and equity). The starting point for the economic literature on capital structure is a theorem proposed by Modigliani and Miller (1958), which states that the specific ratio of corporate debt and equity has no impact on the value of the firm (Villamil 2008). The *Modigliani–Miller Theorem* assumes that markets are efficient and there no taxes or bankruptcy costs. However, financial economists recognize reality is very different from this economic model, and that in practice the ratio of debt to equity does have important implications for the firm and its value. Thus, alternative approaches in the literature on capital structure aim to identify the specific factors that influence decisions regarding the use of debt and equity as sources of external finance (Titman & Wessel 1988). Besides agency theory, these include the *trade-off theory*, in which firms balance the tax

advantages of debt against the costs of financial distress, and the *pecking-order theory*, in which decisions about capital structure are explained as attempts to mitigate problems created by differences in information (Myers 2003).

Alongside these major approaches to capital structure, there is a less known strand of research that is especially relevant in the present context. Studies in this strand suggest that decisions regarding capital structure are influenced by labor-related issues. Similar to the central hypothesis in the present research, these economists argue that corporate debt can be effectively used to extract wage concessions from workers and counter unionizations attempts. What makes these studies especially compelling evidence is their lack of concern with the impact of corporate debt on income inequality or the power of organized labor. Here collective bargaining and the power of unions are used to explain the observed managerial decisions regarding the use of debt as a source of finance. Stated differently, these economists take labor as an independent variable and explore its impact on the ratio between debt to equity, which serves as an outcome variable. When they do discuss the influence of high debt on income distribution within the corporation, they tend to view it favorably. Rather than worrying about debt as a factor contributing to income inequality, they emphasize the benefits of using corporate debt to counter “the threat of unionization” (Bronars & Deere 1991: 232), and suggest that it can be effectively used to protect shareholder wealth by “limiting the appropriation of rents by workers” (Woods, Tan, & Faff, 2019: 28).

Interestingly, the idea that debt can be used to influence wage negotiations was first brought forth in the early 1980s, around the same time agency theory was also gaining popularity. Its roots can be traced back to Baldwin (1983), who suggested that debt can be used to enforce “wage discipline” when workers are concerned about the costs of bankruptcy. As we will see in

later chapters, it was around the same time that the practice of *strategic bankruptcy* also became more widespread, something that more than likely contributed to this scholarly interest.

The scholarship on the link between corporate debt and labor relations came into its own in the early 1990s, with a series of theoretical and empirical studies that explored this relationship in greater depth. Bronars and Deere (1991) provide what is probably the earliest article in this specific strand of research. They suggest that corporate debt can serve as an “an effective tool for reducing the impact of unionization on shareholder wealth” (p. 238), since by issuing more debt, “the firm can credibly reduce the funds that are available to a potential union... Hence the use of debt is quite effective in preserving shareholder wealth” (p. 252). Bronars and Deere recognized that paying higher wages to workers can also reduce the probability of unionization attempts. However, this would mean shifting income from shareholders to workers, which is unlikely to be viewed favorably by investors. The alternative option, they suggested, is to rely more on debt than equity as a source of external finance, which will put firms under an obligation to pay a portion of their future revenues to creditors. “Hence, these obligations limit the revenues that a union can extract without driving the firm into bankruptcy” (pp. 231-232). Bronars and Deere hypothesized that firms with a higher chance of unionization attempts will choose a higher debt-equity ratio relative to firms that are less likely to face such “threats”. They test their hypothesis using data from COMPUSTAT and the Employer Costs for Employee Compensation survey published by the Bureau of Labor Statistics, and find that “empirical evidence gives strong indication that firms do respond to the threat of unionization by increasing their debt-equity ratios” (p. 252).

Perotti and Spier (1993) investigate the role of debt on the bargaining power of workers, suppliers, and creditors. They present a model of temporarily high leverage, which shows that by

issuing more debt, “the shareholders credibly threaten not to undertake valuable new investment unless the union concedes to wage reduction” (p. 1131). They conclude that “capital structure serves as an effective bargaining tool for shareholders when the firm is currently not earning enough” (p. 1138). Importantly, Perotti and Spier note that the strategic use of corporate debt can help explain certain economic developments during the 1980s, including the rise of leveraged buyouts (LBOs) and the spread of stock buybacks. They argue that “the strategic motives identified by our theory may help us to understand recent developments in the financing of U.S. corporations” (p. 1131).

Dasgupta and Sengupta (1993) also focus on the impact of corporate debt on wage negotiations, clearly laying out the logic behind the strategic use of debt. “Suppose that the firm unilaterally raises debt before bargaining occurs with labor unions”, the two economists write. “Then, at the time of bargaining, the size of the divisible pie is effectively reduced... Suppose now that the bargaining outcome involves the workers getting a fixed fraction of the divisible surplus. Thus the share of the revenue going to workers will be reduced as a result of higher debt choice... the share of workers is lower, so that the owner must benefit” (pp. 203-204). The article itself is devoted to developing a theoretical model that shows the impact of debt on the bargaining power of management and labor.

Hanka (1998) also provides a clear statement of the logic behind the strategic use of debt. He explains that “surplus from a firm’s operations must be split... according to managerial discretion and stakeholder bargaining power. Some of the surplus may be captured by employees as higher wages or job security. This is harder if the surplus has been contractually promised to debtholders” (p. 245). Using data from COMPUSTAT for the period 1950-1993, Hanka finds that higher levels of debt are associated with a decline in wages and reduction in employment.

He concludes that “debt can increase shareholder wealth by reducing production costs” (p. 280).

In a more recent study, Klasa, Maxwell, and Ortiz-Molina (2009) find evidence that firms in more unionized industries strategically hold less cash to gain bargaining advantages over labor unions and “shelter” corporate income from their demands. They conclude that “by holding smaller cash reserves, a firm is able to make a more credible case that the risk of liquidity shortages threatens its competitive viability, and as a result, it is unable to concede to union demands” (p. 440). Matsa (2010) argues that high levels of corporate liquidity can encourage workers to raise their wage demands. He suggests that firms use debt as a “strategic variable” to improve their bargaining power with workers (p. 1228). Other studies provide similar results (e.g. Benmelech, Bergman, & Enriquez 2012; Sun Choi, Sohn, & Seo, 2016; Schmalz 2018). It is also noteworthy that in this economic scholarship, unlike the literature on financialization and income inequality, the agency of workers and unions is clearly recognized. Chen, Kacperczyk, and Ortiz-Molina (2012), for example, argue that strong unions can limit the level of debt issued by the firm, and suggest that unionized workers “have strong incentives to monitor management’s actions to ensure that the firm remains healthy” (p. 352). Woods, Tan, and Faff (2019) find that following the approval of right-to-work legislation, which undermines the power of organized labor, firms tend to increase their financial leverage. They suggest that strong unions can “crowd-out” financial leverage and reduce the debt capacity of the firm. Simintzi, Vig, and Volpin (2014) find a negative correlation between labor-protection legislation and financial leverage. These studies suggest that the impact of corporate debt on income inequality is not fixed in advance, but depends on the existing balance of power between labor and capital, and should be understood as part of the ongoing class struggle rather than a force shaping its trajectory from the outside.

Given all these findings, it is not surprising that in the preface of *The Handbook of Corporate Finance: Empirical Corporate Finance*, Eckbo notes (2007) that debt can be used to “protect shareholder wealth by moderating union wage demands” (p. xv), and that another textbook titled *Financial Markets and Corporate Strategy* states that “by increasing leverage, the firm can reduce its employees’ demands by exploiting their fear that a wage increase will push the firm towards bankruptcy” (Hillier, Grinblatt, & Titman 2012: 562).

The economic literature reviewed above provides strong support for the central hypothesis of the present research, i.e. that corporate debt serves as a strategic weapon in the class struggle between labor and capital. However, like the existing scholarship on financialization and income inequality, the empirical sections in these studies consist of statistical tests and quantitative analysis, which tells us very little about how this strategic use of corporate debt came into being, how it is deployed in practice, or how workers respond to such pressures. One exception to this trend is provided by Hanka (1998), who argues that the relationship between debt and wages is not stable but changes with time. Importantly, Hanka finds that the association between debt and wages became statistically significant only in the early 1970s, noting that this change was “roughly coincident with a sharp overall rise in debt levels, but does not seem to have been caused by debt exceeding some critical threshold, or by broader changes in the relations between debt and business risk” (p. 280). Instead, Hanka suggests that it might be related to the emphasis on maximizing shareholder value, increasing competitive pressures from foreign corporations, or the oil shock of 1973-1974. He concludes that “pinpointing the relevant events might yield, and might require, a deeper understanding of both debt and the employment relationship” (p. 278).

Hanna’s conclusions provide a useful segue to the next chapter, which examines of the shift toward finance during the 1970s as part of the historical development of the class struggle in the

U.S. economy. The analysis it provides, which “pinpoints the relevant events” linking debt and labor struggles, lays the historical foundations for a closer investigation of the strategic use of corporate debt in the U.S. auto, steel, and airline industries that is presented in chapter 4.

Chapter 3. Financialization as a Historical Trend: Bringing Class Struggle Back In

Introduction

The present chapter provides the historical context in which corporate debt became a strategic tool used to extract concessions from workers. My goal is not to offer anything close to a full historical analysis of financialization, its multiple causes and various outcomes. Instead, I seek to: (1) show how existing accounts can be reframed within a class struggle framework, and (2) draw out the relevant implications for the subsequent analysis of corporate debt and labor relations in the U.S. economy during the economic recessions of the early 1980s.

Most scholars agree that financialization is more than a secular growth in certain economic indicators, and reflects a deeper transformation in the structure of capitalist societies. As mentioned before, the historical roots of this transformation are usually traced to the decline of the economic expansion that followed World War II and the economic problems that persisted through the 1970s. The shift toward finance is often viewed as a response to these difficulties, which helped alleviate the economic malaise of the decade. However, the nature of the solution that scholars argue is provided by financialization varies according to the theoretical framework and the specific research interests. Within sociology, these include an organizational approach used in the scholarship on the SV doctrine (e.g. Fligstein 1993; Dobbin & Zorn 2005; Fligstein & Shin 2007; Dobbin & Jung 2010; Shin 2013; Heilbron, Verheul, & Quak 2014), and a state-centric approach used by Krippner (2011).

In the scholarship on the rise of the SV doctrine, it is the new paradigm of corporate governance that is said to provide a solution to the problem faced by American corporations following the decline of the postwar era. Central to the theoretical framework used in these studies is the notion of an *organizational field*, generally defined as a group of interrelated organizations and

the environment in which they interact (DiMaggio & Powell 1983; Aldrich & Ruef 1999; Scott 2008). Such an organizational field includes a set of rules and norms, as well as cognitive frameworks and shared understandings through which actors in the field perceive and understand the environment in which they operate. External developments can destabilize the field and undermine the established “rules of the game”, providing an opportunity for competing economic actors to advance a new set of practices and strategies that are presented as a solution to these novel challenges.

In the scholarship on shareholder value, the economic turbulence of the 1970s provided such an opportunity. It allowed institutional investors, financial analysts, and hostile takeover firms to bring forward a new model of corporate governance in which the main responsibility of corporate managers, and possibly the only one, is to maximize the returns to their shareholders. This new model fit well with the then-novel “agency theory”, developed by financial economists to address the principle-agent problem arising from the separation of ownership and control in the modern corporation (e.g. Jensen & Meckling 1976; Jensen 1986). Managers were persuaded to come onboard with the promise of increased income through stock-based compensation, which helped align their incentives with the interests of shareholders. Firms that resisted the new set of financial demands became targets for hostile takeovers in the waves of mergers and acquisitions that swept through U.S. corporate sectors during the 1980s (Fligstein 1993; Dobbin & Zorn 2005; Dobbin & Jung 2010; Shin 2013; Heilbron, Verheul, & Quak 2014).

Although the scholarship on shareholder value pays little attention to the escalating class struggle during the 1970s, the problems it identifies in the organizational field of American corporations are closely related to this development. Corporations, after all, are not located outside of the class structure of society, and the problems they face also depend on the broader social relations that

structure their organizational field. What is considered a problem to be solved depends not only on the existing economic conditions, but also on the specific social location from which such problems are perceived. The “cognitive framework” of an organizational field is from the very start implicated in a specific class perspective. For example, high labor costs that cut into corporate profits will probably be viewed as a problem from the perspective of managers and shareholders, but workers are not likely to share this sentiment. Practices that reduce these costs will be viewed as a solution from the perspective of capital, but are likely to be regarded as the problem from the side of labor.

Krippner (2011) offers a different perspective on the problem financialization solves. She argues that it provides a solution for state officials and policymakers, by allowing them to avoid the social and political dilemmas related to the provision of credit in the face of rising inflation. In her account, financial deregulation allowed the state to transfer responsibility for such decisions to the market and avoid a direct conflict with the various social groups competing for these resources. She sees the turn toward finance as an improvised rather than a planned process, which developed according to contingent “discoveries” made by policymakers.

While the social unrest of the 1970s plays an important role in Krippner’s account, the state itself remains above these struggles and enjoys a “relative autonomy” from the influence of ruling classes. This conception of the state becomes problematic when we consider the extensive evidence of the political mobilization of corporate America during the period (e.g. Ferguson & Rogers 1987; Neustadt & Clawson 1988; Goldfield 1989; Akard 1992; Himmelstein 1992; Gindin & Panitch 2012; Kolin 2016). It is likely that policy-making processes in general, and not only in the case of financialization, are more improvised than they appear from the outside. However, this does not mean that the direction these policies take is coincidental. Regardless of

how they came into being, the policies adopted by the Reagan administration during the 1980s can hardly be described as impartial to the struggle between labor and capital. Given this record, the fact that financial deregulation also ended up undermining the power of workers seems an unlikely coincidence.

The alternative approach adopted in this chapter maintains some of the insights provided by these existing accounts, but incorporates them within a broader framework that emphasizes the dynamics of class struggle as essential for understanding the shift toward finance. Rather than simply seeing it as one of the problems facing American corporations during the 1970s, I suggest that the crisis of profitability and the problem of inflation should be understood from within this narrative of class struggle. Stated differently, I suggest that the relationship between foreign competition and corporate profitability and between monetary policies and inflation is mediated through the class struggle between labor and capital. By reframing the economic problems of the 1970s in class terms, the relationship between financialization and income inequality is brought closer to the surface.

The rest of the chapter is divided into three sections. The first section reviews the way existing accounts of financialization present its historical development. It shows that the economic problems of the 1970s, to which these accounts argue financialization is a response, are also the outcome of successful struggles waged by workers since the late 1960s. The second section re-examines the role of the state in the turn toward finance, seeing it not as an independent actor but as a terrain of this ongoing class struggle. It reviews the increased political mobilization of large corporations since the early 1970s, and the alliance between finance and industry that helped bring Paul Volcker to the position of chairman of the Federal Reserve. The third section reviews specific changes in *property relations* which accompany the growing importance of financial

assets as a form of property. These include the incorporation of credit rating agencies into the regulatory framework of financial markets and the reform in bankruptcy laws passed by the U.S. Congress in 1978. It explains how these changes provided the necessary conditions for the strategic use of corporate debt in collective bargaining, which became widespread in the early 1980s, and created a channel through which financialization has contributed to rising income inequality.

The historical roots of financialization

The existing literature traces the historical roots of financialization to the decline of the postwar era, often considered “the golden age of capitalism” (Marglin & Schor 1991). This period, which lasted from the end of the war to the early 1970s, was a time of unprecedented economic expansion for the global economy. In North America, Western Europe, Japan, and the Soviet Union, rates of growth reached historical heights, and labor markets experienced close to full employment. Global output of manufacturing sectors increased fourfold between the early 1950s and the early 1970s, and world trade in manufactured goods grew eightfold (Glyn, Hughes, Lipietz, & Singh 1991). This long stretch of global prosperity came to an end with the oil crisis of 1973 and the recession of 1973-1975 in Western economies, which brought global growth down sharply.

In the U.S. economy, hints of the decline of the postwar era were already evident in the late 1960s, as a slowdown of growth developed into a full recession in the final months of the decade, ending what was, until then, the longest period of economic expansion in U.S. history. From the mid-1960s, growing government deficits stemming from the Vietnam War and expansion of welfare programs pushed up inflation, prompting the Federal Reserve to tighten its monetary policy, a move that led to the “credit crunch” of 1966 (Burger 1969).

This rising inflation undermined international trust in the U.S. dollar, which had served as anchor currency of the global economy since 1944. Under the international monetary system established at Bretton Woods, all national currencies were pegged to the dollar, which was the only currency fully convertible to gold. Rising inflation eroded the real value of the U.S. currency, and made it harder and harder to maintain the conversion rate of \$35 for an ounce of gold set at Bretton Woods. As a “run on gold” depleted U.S. reserves, President Nixon decided to suspend the convertibility of dollars to gold in August 1971, effectively abolishing the Bretton Woods system of regulated exchange rates. The transition to a monetary system based on floating exchange rates prompted a surge of financial liberalization and deregulation.

These problems in the U.S. economy continued throughout the 1970s. The unemployment rate, which averaged around 3.8% from 1965-1969, rose to 5% in 1970 and 6% in 1971. Following the oil crisis and the recession of 1973-1975, the American labor market lost about 2.3 million jobs, and unemployment reached a high point of 8.6%. The combination of rising prices and high unemployment, which had previously been thought to be inversely related, contributed to the decline of Keynesian theories and the rise of monetarism as a dominant school of economic thought.

Crisis of profitability

After dominating global markets since the end of WWII, from the mid-1960s American corporations faced increased foreign competition. Large NFCs saw their market shares shrink as imported goods increasingly penetrated their domestic markets. At the same time, the growth of productivity in the nonfinancial corporate sector started to decline (Okun & Perry 1970). Real output per hour, which grew at an average rate of 3.3% in the first half of the decade, slowed down to an average of 1.6% between 1965 and 1969 (U.S. Bureau of Labor Statistics 2020). The

rate of profit for the nonfinancial business sector (calculated as profits before tax divided by assets at historical costs) declined from 8.8% in 1965 to 5.4% in 1970. As a share of the Gross National Product (GNP), corporate profits declined from 11.1% to 7.1% during the period (Nordhaus 1974).

In the scholarship on the rise of shareholder value, the crisis of profitability is portrayed as central to the shift toward finance. The failure of existing approaches to corporate governance opened up the space for competing economic actors to put forward their own ideas regarding the best ways to make money in this new business environment (Fligstein 1993). From this contest of ideas, the shareholder value doctrine emerged victorious.

Economic sociologists are certainly right to emphasize the crisis of profitability as central to the rise of finance. However, corporate managers did not sit idle until a new model of corporate governance emerged. Rather, they tried to resolve the problem by increasing their productivity while holding down wages. Between 1967 and 1973, capital investments for the U.S. NFCs grew at a record rate of 4.3% per year (adjusted for inflation), compared with an average of 3.1% through most of the postwar era (Gindin & Panitch 2012). However, productivity growth lagged behind the growth in wages, as workers mobilized to resist the reorganization of work that accompanied the increased rate of investment.

This mobilization of labor is evident in the increased frequency and scope of labor disputes and strikes from the mid-1960s (figure 3.1). While in the first half of the decade there were an average of 3,600 work stoppages per year, in the second half the average number of work stoppages was higher than 5,000 per year. The number of large strikes (involving 1,000 workers or more) rose from around 220 per year in 1961-1965 to 377 per year in 1966-1970, while the number of workers involved in these activities was more than twice as high (U.S. Bureau of

Labor Statistics 1982). These struggles only intensified as the decade came to a close. The number of strikes in 1970 rose to a record of 5,716, and the number of idle days due to these activities was 55% higher than in 1969 (U.S. Bureau of Labor Statistics 1972).

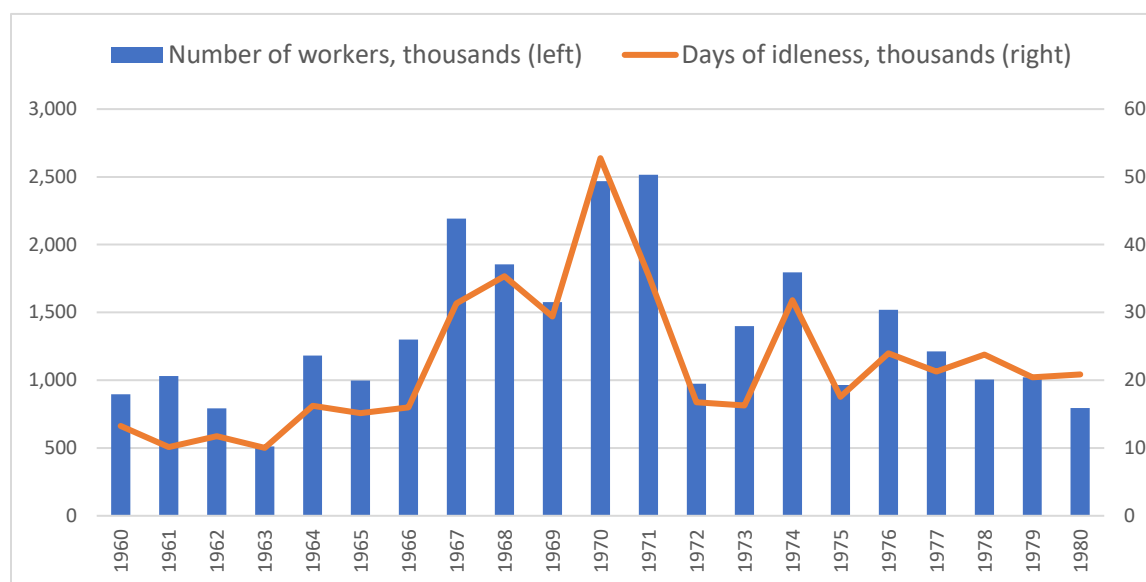


Figure 3.1 Workers' participation in strikes and resulting idle days, 1960-1980

Source: U.S. Bureau of Labor Statistics

That this mobilization was indeed successful is evident in the distribution of corporate income during these years (figure 3.2). While total corporate profits as a share of gross domestic product (GDP) declined from 12.1% in 1965 to 8.2% in 1970, the labor-share paid as compensation rose from 51.8% to 55.1%. This trend is even more dramatic in manufacturing, where profits declined from 18.4% to 10.1% of the industry GDP, while the labor-share grew from 66.2% to 73.1% (U.S. Bureau of Economic Analysis 2019).

The class perspective adopted in this research also helps explain the specific prescriptions of the shareholder value doctrine, which was never much concerned with foreign competition or inflationary pressures. Practices such as increased dividend distribution, stock buybacks or the substitution of debt for equity were not intended to take back lost market shares or improve productivity. They had nothing to do with the creation of “new” value, but with the distribution

of value already produced. These practices can be explained at the individual level, as a rational behavior of corporate managers, but this rationality itself is conditioned by the existing relations of production, and as noted before, reflects a specific standpoint within the social structure.

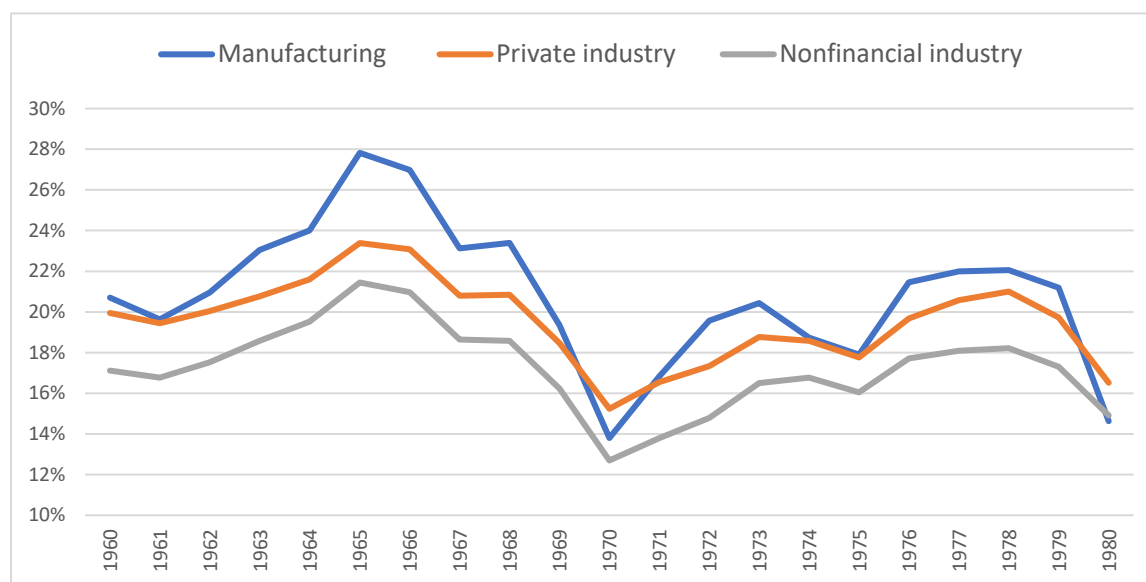


Figure 3.2 Ratio of corporate profits to compensation, 1960-1980

Source: Own calculations based on data from the U.S. Bureau of Economic Analysis

The great inflation

Inflation, which remained below 2% during most of the postwar era, averaged above 6% annually in the first half of the 1970s and rose to higher than 8% in the second half of the decade. Together with the crisis in profitability, the “great inflation” of the 1970s was the second major problem facing the U.S. economy.

Although the oil crises of 1973 and 1979 certainly contributed to this trend, inflation is also the outcome of “deep-rooted social and economic contradiction and conflict” (Tobin 1989: 318).

While such conflict can manifest itself as a struggle between consumers and producers, or between importers and exporters, many commentators during the period pointed to the conflict between workers and employers and the struggle over wages as central to the inflationary spirals of the 1970s (e.g. Sachs 1978; Hirsch & Goldthorpe 1978; Bowels & Gintis 1982).

Consumer prices in the U.S. started to accelerate from the mid-1960s, with their annual rate rising from 1.6% to 5.7% by 1970. This trend was underlined by an ongoing struggle between workers, who were striving to protect the purchasing power of their wages, and employers, who were looking to maintain their profit rate. This created occasional episodes of “wage-price spiral”, in which higher prices prompted wage increases to compensate for rising costs of living, which in turn led managers to raise prices even more and so on (Hirschman 1981; Blanchard 1985). In this sense, inflation can be viewed as a “monetary expression” of class struggle (figure 3.3). It reflects a “distributional conflict between a working class, demanding both employment security and a higher share in their country’s income, and a capitalist class striving to maximize the return on its capital” (Streeck 2011: 11).

The inflationary spirals of the 1970s were a major cause of concern for investors - shareholders and bondholders alike - who saw how fast-rising prices eroded the value of their financial assets and reduced the returns on their investments. These concerns were articulated in May 1977 by the famous investor Warren Buffet, CEO and chairman of Berkshire Hathaway. In an article published in *Fortune Magazine* under the title “How Inflation Swindles the Equity Investor”, Buffet complained that “inflation is a far more devastating tax than anything that has been enacted by our legislatures”. Buffet explained that stocks, in contrast to bonds, are often considered as a “hedge” against inflation, since investors believe that they would retain their value in real terms irrespective of inflation. However, Buffet warned, economic reality proved these beliefs to be unfounded. The reason, in his opinion, is that “stocks, in economic substance, are really very similar to bonds” (Buffet 1977: 250). The same concerns led some economists to contemplate the possibility of creating a market in which investors could trade in futures contracts whose values are tied to inflation (e.g. Lovell & Vogel 1973; Dew 1978). As one

economist explained, “the absence of a hedge against inflation is driving many investors away from financial assets... in a CPI futures market, investors... can use the contract to hedge purchasing power risk” (Ederington 1980: 42).

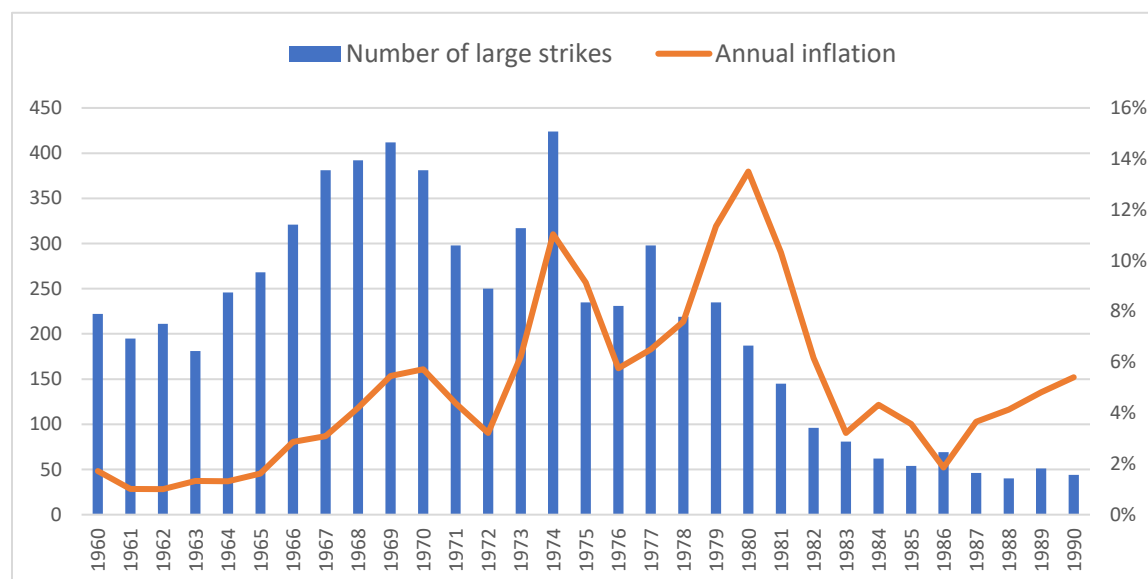


Figure 3.3 Annual work stoppages and inflation, 1960-1990

Source: Federal Reserve Bank of St. Louis and U.S. Bureau of Labor Statistics

What concerned Buffet and other investors was the *inflationary risk* of investments in financial securities, i.e. the risk that inflation will undermine the return on investments. This risk is related to the specific form of this type of property, which represents a contractual claim on future income. The price of a financial security is derived from the cashflow it is expected to provide, as opposed to the price of physical assets, which is based on already-existing value. As one expert on financial valuation explains, “we buy financial assets for the cashflows we expect to receive... which implies that the price we pay for any asset should reflect the cashflows it is expected to generate” (Damodaran 1994: 1). The problem is that inflation reduces the current value of this future income, since rising prices mean that this future sum of money would have less purchasing power. In other words, higher inflation means that future payments are also discounted at a higher rate. Thus, higher inflation means that future income will be worth less in

current terms, which will be expressed in a lower price for the financial security.

The impact of inflation on the prices of financial securities can be gauged by examining the average *price-to-earning* (P/E) ratio of U.S. corporations, which is calculated by dividing the price of the stock by earnings-per-share (EPS). P/E ratio (also known as “earnings multiple”) is a widely used benchmark in valuation of financial securities (Damodaran 1994). For the same level of earnings, a lower P/E ratio means a lower stock price, which might mean that investors are pessimistic about the future, or might indicate that the stock is under-valued. High inflation means that the same level of current earning will be worth less in future terms. An annual inflation of 8%, for example, means that nominal earnings must grow by 8% to maintain their real value. Other things being equal, expectations of higher inflation will lead investors to demand higher earnings for the same share price, which will be reflected in a lower P/E ratio. This was indeed the situation through most of the 1970s and early 1980s, which explains the concerns of investors like Warren Buffet (figure 3.4).

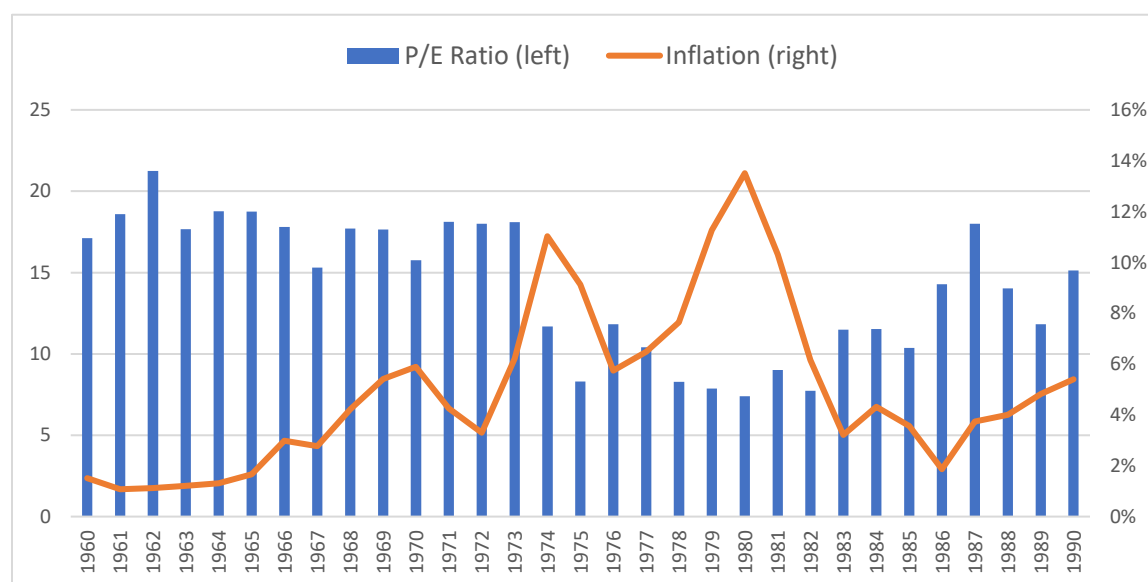


Figure 3.4 Inflation and price-to-earning (P/E) ratio of S&P 500 companies

Source: Own calculations based on data from the Federal Reserve Bank of St. Louis and online data provided by the economist Robert Shiller at <http://www.econ.yale.edu/~shiller/data.htm>

The problem of high inflation was only overcome in the early 1980s, when Federal Reserve chairman Paul Volcker pushed interest rates to an unprecedented height with the explicit goal of “breaking the back of inflation”. This policy shift, which later became known as the “Volcker Shock”, is considered by many to mark the beginning of the neoliberal era and an important step toward the financialization of the U.S. economy (e.g. Helleiner 1996; Dumenil & Levy 2004; Harvey 2011; Mahmud 2012).

The state as a terrain of struggle

The focus on corporate governance is too narrow to account for the rise of shareholder value. The practices associated with this model would not be effective, and in some cases even possible, without the intervention of the state and its various agencies through legal and regulatory changes. Stock buybacks, for example, were considered a form of price manipulation before the turn towards finance. They were officially authorized only in 1982, when the SEC provided a “safe harbor” clause against such manipulation charges (Lazonick 2014).

Criticizing the treatment of the state in existing studies, Krippner (2011) suggests that the rise of finance was also driven by the attempts of state officials to avoid tough decisions related to credit provision in the U.S. economy. She argues that financialization was an unplanned outcome of such efforts, and developed according to contingent discoveries made by policymakers. She specifically criticizes the tendency to impute too much coherence on the state “by assuming a seamless alliance between government officials and business elites” (Krippner 2011: 13).

Krippner is certainly right to argue that the state is more than a “managing committee” for the common interest of the capitalist class. However, the idea that state officials act as impartial arbiters in the conflict between labor and capital is hardly convincing, given the extensive

evidence of the political mobilization of corporate America during this period. Far from being external to the class struggle, the state served as an increasingly important terrain on which such battles were waged and won. The direction taken by policymakers was strongly shaped by these outcomes, and must be understood in relation to the development of the class struggle.

The political mobilization of corporate America

There is an extensive literature on the political mobilization of corporate America and its contribution to the conservative shift in U.S. politics during the 1970s (e.g. Ferguson & Rogers 1987; Clawson & Neustadt 1989; Goldfield 1989; Akard 1992; Himmelstein 1992; Phillips-Fein 2010; Gindin & Panitch 2012; Kolin 2016). Big business provided free-market advocates greater access to funding and political influence, helped spread conservative ideas to the general public, and assisted in transforming right-wing economic theories into government policies. Its support was central to the election of Ronald Reagan to the presidency in 1980, which some view as the culmination of a decade-long effort (e.g. Piven & Cloward 1982; Ferguson & Rogers 1987).

It was during this period that business associations like the U.S. Chamber of Commerce, the National Association of Manufacturers, and the Business Roundtable became widely recognized as influential actors (Phillips-Fein 2010; Walker & Rea 2014). Business organizations led the formulation of specific policy proposals and lobbied congressional leaders and top officials in the executive branch, while more specialized organizations mobilized ‘grassroots’ political pressure (Akard 1992). They extended support to a growing network of conservative think-tanks and policy centers such as Mellon-Scaife, Olin, and Smith Richardson foundations, and by the late 1970s, large corporations and trade associations were spending hundreds of millions of dollars on advocacy advertising (Himmelstein 1992; Peck 2010; Jones 2012). Between 1978 and 1980 the average share of corporate contributions to Republican challengers increased from

17.4% to 29.3% (Burris & Salt 1990). On average, corporate PACs' contributions to Republican candidates were about twice as high as their contribution to Democrats in the 1978-82 elections.

Central to this growing unity within the capitalist class was the alliance between large U.S. manufacturers and major financial institutions. Already in the 1930s, an alliance between capital-intensive, multinational corporations and large financial institutions was at the center of Roosevelt's "new deal coalition" (Ferguson & Rogers 1987). Beginning in the late 1960s, conservative think-tanks and pro-business organizations worked to bring together representatives from financial institutions and large industrial corporations (Himmelstein 1992). This alliance of financial and multinational corporations (MNCs) led the charge against government regulation, social spending and "excessive taxation" of corporate income (Ferguson & Rogers 1987). Cross-industry coalitions were formed to defeat the Foreign Trade and Investment Act of 1973, which would have put in place import quotas and restrictions on export of capital, and to ensure the approval of the 1974 Trade Act, which gave large businesses more influence on trade policies (Gindin & Panitch 2012).

The alliance between finance and industry only became stronger with the great inflation of the 1970s and the escalation of the class struggle. After a decade of economic malaise, most industrial sectors "had come to accept the need to give priority to fighting inflation and defeating labor, and agreed that the strengthening of financial capital this would involve was in their own interest" (Gindin & Panitch 2012: 163). It is in this context that we can understand the Volcker Shock" as a form of class warfare more than, or in addition to, a "war on inflation".

The appointment of Paul Volcker as chairman of the Federal Reserve marked an important victory for capital in the class struggle and a critical step in the rise of finance. It was a clear signal to investors and the financial industry that their grievances would be addressed (Epstein

1985). Carter was insistent on appointing a chairman who had the blessing of the financial sector. He first offered the position to David Rockefeller, CEO and Chairman of Chase Manhattan Bank, the investment banker Robert Roosa, and Alden W. Clausen, chairman of Bank of America, all of whom refused (Ferguson & Rogers 1987). Stuart Eizenstat, a domestic policy advisor in the Carter administration, stated: “Volcker was selected because he was the candidate of Wall Street. This was their price” (quoted in Greidner 1989: 47).

The financial press also emphasized the respect Volcker commanded among bankers and investors, noting that his strong anti-inflation stance enjoyed wide support in the financial community in the U.S. and abroad. He worked in Chase Manhattan Bank between 1957 and 1962, and returned to the bank in 1965 after a short period in the U.S. Treasury, serving as its vice president until 1969. At Chase, he befriended David Rockefeller, and occasionally prepared him for testimonies before congressional committees. According to Volcker, the two remained close until Rockefeller’s death in 2007 (Volcker & Harper 2018).

Volcker’s close ties to the financial sector were hardly a secret, and were actually lauded in the financial press as one of his strong points. The issue was addressed a little more critically in his confirmation hearings. Senator William Proxmire, chairman of the Committee on Banking, Housing, and Urban Affairs, praised Volcker for his competence and experience, but added that he is viewed as a hard money, big business conservative. “To many people in the country”, Proxmire told Volcker, “you may be the personification of Wall Street and international banking. It isn't always a favorable view, as you know” (U.S. Congress 1979a: 3).

Volcker’s appointment, the *Washington Post* reported, “was hailed almost unanimously on Wall Street and in financial centers abroad” (Pine & Berry 1979). According to the *New York Times*, “European monetary officials and bankers” also welcomed the nomination (Lewis 1979). The

Canadian *Globe and Mail* reported that the decision “was applauded enthusiastically by U.S. bankers and foreign officials” (Silk 1979). Clausen, CEO of Bank of America, viewed the appointment as “good news”, while Rockefeller said that Volcker “is precisely what our country needs” (The American Banker 1979). John H. Perkins, president of the American Bankers Association, expressed a similar sentiment, which was also felt in the financial markets: following the announcement, “the stock market rose sharply and the bond market began a ‘Volcker rally’” (Facts on File World News Digest 1979).

The Volcker Shock as class warfare

There can be little doubt that for Volcker, “breaking the back of inflation” necessarily meant holding down wages. Volcker himself was quite explicit on this point. In a meeting with the American Bankers Association in October 1979 he expressed his hope that “the whole wage bargaining process... will not proceed oblivious of the problems of inflation” (Volcker 1979: 3). In February 1980 he told the Joint Economic Committee that with the decline in growth “it is even more apparent that moderation in wage growth is needed if we are to gain control over inflation” (Volcker 1980: 15). In testimony before the Senate Banking Committee in July 1980, he emphasized the need for wage restraint to assist in the battle against inflation (Atkinson 1980). A few months later he told a House subcommittee that it is impossible to fight inflation unless steps are taken to slow the rate of wage increases (Slevin 1980). In short, Volcker “wanted wages to fall, the faster the better” (Greidner 1989: 429).

With Volcker at the helm, the Federal Reserve adopted a tighter monetary policy that involved targeting the money supply and raising the federal funds rate to double digits.⁴ This policy shift

⁴ The federal funds rate is the interest rate that depository institutes (banks and credit unions) charge each other for lending their reserve balances on an overnight basis.

drove the U.S. into a sharp recession, as the economy contracted by more than 2% in the first half of 1980 (i.e. real GDP declined by 2%). Unemployment, which was already at 6% when Volcker took office, rose to 7.8% by June 1980. It remained above 7% even as the economy showed signs of recovery in the first half of 1981, and jumped to 8.5% by the end of the year, as the U.S. entered another recession, which was more severe than the previous one. It continued to rise through 1982, reaching 10.8% by the end of the year – the highest level recorded since December 1940.

The potential implications of raising interest rates to unprecedented levels were well-known in advance. During Volcker's confirmation hearing, Senator Proxmire asked him to address the fears that he may choose to push interest rates "to levels that would be punishing and create more unemployment and be very difficult for small business, the farmer, and the working people." Volcker avoided a direct answer and only stated that he did not want interest rates to be "any higher than they have to be", and that it would not be appropriate "to comment on what particular moves might be necessary or desirable" (U.S. Congress 1979a: 3).

Volcker himself clearly understood the potential outcomes of his monetary policy. A few months after his appointment he met with the senior editors of the *Wall Street Journal*, and asked them if they will still support him "when there's blood all over the floor." George Melloan (2003), deputy editor at the time, noted years later that "there was blood indeed."

That holding down wages meant a conflict with organized labor was also quite clear. In his pocket, Volcker carried a card on which he kept track of the collective agreements signed by major trade unions (Greidner 1989: 429). When Chrysler was facing bankruptcy and asked the government for an emergency loan, Volcker became a member of a three-man committee to

oversee the bailout.⁵ In that capacity, he invited Doug Fraser, the president of the United Automobile Workers (UAW) union, to meet in his office, pressuring him to accept significant cuts in wages and fringe benefits. According to Volcker, Fraser “later reportedly said I was the toughest negotiating counterparty he ever had” (Volcker & Harper 2018: 122)

Perhaps most telling is the praise Volcker gives President Reagan for breaking the Professional Air Traffic Controllers Organization (PATCO) strike in 1981, which he regarded as the most important contribution of the administration in the fight against inflation. In his memoir he acknowledged that the strike was aimed at working conditions more than wages, but insisted that “the union defeat sent a powerful psychological message that there would be limits on wage demands” (Volcker & Harper 2018: 113-114). In a private interview he stated that the breaking of PATCO did “even more to break the morale of labor” than had the earlier “breaking of the pattern of wage push in the auto industry” (quoted in Gindin & Panitch 2012: 172).

The impact of the “Volcker Shock” went far beyond domestic markets and the American working class. It was especially devastating in Latin America, where it led to sovereign debt crises that drove Mexico into bankruptcy and forced Brazil, Argentina, Chile, and Bolivia to seek the assistance of the International Monetary Fund (IMF). This crisis was used by the IMF and local elites to implement neoliberal policies (Harvey 2011; Clift & Tomlinson 2012). Trade unions in Latin America and Europe recognized Volcker’s role in these developments, and before his re-nomination hearings, the Senate Committee on Banking, Housing, and Urban Affairs received letters and messages expressing their objections. “In the name of thousands of workers”, stated a letter from a Colombian union, “we reject the policy of high interest rates

⁵ According to Volcker, it was Senator William Proxmire, chairman of the Committee on Banking, Housing, and Urban Affairs, who insisted that he serve on the bailout committee (Volcker & Harper 2018: 121).

which has caused poverty, misery and unemployment. We expect the non-confirmation of Mr. Paul Volcker.” A West-German white-collar unionist explained that due to Volcker’s policies, “unemployment figures jumped up... and real wages decreased. We still remember quite well how in 1980 Volcker demanded to lower workers' living standards” (quoted in U.S. Congress 1983a: 97).

In Latin America, the monetary policy adopted by the Federal Reserve turned sovereign debt into “a weapon against the working class” (Cleaver 1989: 38). Within the U.S. economy it had a similar impact on corporate debt, turning it into a strategic tool that was successfully deployed in the escalating class conflicts of the early 1980s.

A shift in property relations

The war on inflation reflected the growing importance of financial securities and the increasing need protect the value of this type of property. Gindin and Panitch (2012) note that the broadening and deepening of financial markets, the more extensive markets for commercial papers and the development of new securitized instruments were all crucial to this change in monetary policy. Duménil and Lévy (2004) observe that prioritizing the war on inflation over all other policy goals emphasized the need to ensure the payments to creditors and stockholders. More broadly, Epstein (2001) suggests that the monetary policy of “inflation targeting”, which was increasingly adopted by central banks since the 1990s, meant a greater emphasis on financial asset appreciation as a goal of monetary policy.

The Volcker Shock and the war on inflation should be understood as part of a broader shift in property relations that accompanied the growing centrality of financial securities. This shift included legal changes, new rules and regulations, and public policies specifically designed to protect this form of property. The deregulation of financial markets in the early 1980s was

perhaps the most notable aspect of this shift, but it marked the high-point of a process that started at least a decade earlier, if not before. Among these changes were the Securities Investor Protection Act of 1970, which helped expedite the recovery of missing assets during the liquidation of a failed investment firm; the creation of the U.S. Commodity Futures Trading Commission (CFTC) in 1974 as an independent Federal agency to regulate derivatives; the Securities Acts Amendments of 1975, which was the most comprehensive securities legislation passed by the Congress since the 1930s; and more. Most of these changes remain outside the scope of the present research. However, two specific changes within this broader shift in property are especially important for understanding the use of corporate debt as a strategic tool in the class struggle. These were the incorporation of credit rating agencies into the regulatory framework of financial markets and the Bankruptcy Reform Act of 1978, which paved the way for the practice of strategic bankruptcy that became widespread during the 1980s. In what follows I review these changes and explain their relevance in the present research context.

Credit ratings as a coordination mechanism

Credit rating agencies (CRAs) are firms that estimate and rate the creditworthiness of different borrowers, including corporations, local authorities, and sovereign government. Although privately-owned, CRAs today perform important regulatory functions within financial markets, and are considered important “gatekeepers” alongside market analysts and corporate auditors. This was not the case throughout most of the twentieth century, however, not even in the U.S., where credit rating agencies are most thoroughly integrated into the regulatory framework.

CRAs have existed in the U.S. since the early twentieth century. They were first incorporated into financial regulation as part of the New Deal legislation of the 1930s. Following the Great Depression, U.S. regulators sought to encourage banks to invest in safer debt securities. This led

to a 1936 rule that prohibited banks from investing in "speculative investment securities", with the meaning of "speculative" set by rating agencies (White 2010). In 1951 the National Association of Insurance Commissioners (NAIC) imposed a higher capital requirement on investments in lower-rated bonds. However, until the 1970s, the regulatory role of CRAs remained restricted to the banking system and insurance industry.

Things started to change from 1975, when the SEC adopted a uniform *net capital rule* that designated certain credit rating agencies as "Nationally Recognized Statistical Rating Organizations" (NRSROs). The net capital rule was designed to ensure that investment firms that traded in securities on behalf of clients as well as their own account ("broker-dealers") would be able to meet their financial obligations in case of liquidation. It required broker-dealers to deduct a certain percentage ("haircut") from the market value of their securities to provide a margin of safety against losses from trading in their own account. In 1975, the SEC decided that investments in high-rated debt securities would be subject to a lower capital requirement. For the purpose of the rule, the SEC decided that such ratings must be obtained from "Nationally Recognized Statistical Rating Organizations" (NRSROs). Although this new category was not clearly defined, the SEC designated three credit rating agencies as NRSROs: S&P, Moody's, and Fitch. Four other agencies were designated NRSROs in the following years (Jamroz 1992).

The designation of NRSROs crystallized the regulatory role of CRAs in U.S. financial markets. Other public regulators and government agencies soon followed the SEC in adopting the new category of NRSROs. These included the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision, and the Department of Labor (Sy 2009). In addition, the U.S. Congress incorporated the category of NRSR into a wide range of financial legislation. For example, the Secondary Mortgage Market Enhancement Act of 1984 eased the

regulatory administrative requirements for the issuance of mortgage-backed securities (MBS) with a high credit rating (Kruck 2011).

Since the late 1980s, other countries have increasingly incorporated CRAs in their own regulatory framework (Sinclair 2008). However, it remained most developed in U.S. financial markets. In a systematic review of the use of credit ratings in by U.S. regulators, Kruck (2011) identifies four main types of ratings-dependent requirements: (1) regulators impose risk-sensitive investment restrictions on certain financial institutions (2) regulators have defined different disclosure requirements for issuers of bonds rated by credit rating agencies; (3) credit ratings agencies have been used for defining the conditions for issuing certain financial instruments (e.g. mortgage-backed securities); and (4) regulators have used credit ratings to adjust capital reserve requirements for banks and institutional investors with respect to their credit risk exposure.

In the framework I use in the present research, the incorporation of CRAs into the regulatory framework of financial markets is part of the broader shift in property relations that accompanies the rise of financial securities. The backdrop to the regulatory task assigned to CRAs was the impressive growth in the U.S. securities industry, which expanded at an estimated compounded rate of 20% per year during the 1960s (Mofsky 1971). Concerns about the industry arose following the failures of several investment firms between 1967 and 1970 and the losses incurred by their customers (U.S. General Accounting Office 1998). These concerns led the U.S. Congress to pass the Securities Investor Protection Act (SIPA) of 1970, which established the Securities Investor Protection Corporation (SIPC). The uniform net capital rule of the SEC was meant to address the same concerns.

During the same period, the business model of CRAs underwent a dramatic change. Throughout most of the twentieth century, CRAs earned money by selling publications containing their credit

risk assessments to investors. This business model came under pressure in the 1970s, when credit ratings increasingly became available for free on the newly introduced electronic communication networks for finance. CRAs reacted by switching from subscription-based model to charging borrowers for rating their debt securities. Critical observers argued that this business model created a conflict of interests since it provided an incentive for CRAs to offer more favorable ratings to attract more customers (Kruck 2011).⁶ At the same time, CRAs started to provide finer rating gradations to help investors distinguish more carefully among issuers. In 1973, Fitch started attaching plus and minus symbols to its letter-based ratings. S&P followed suit in 1974, and Moody's joined in 1982 (Cantor & Packer 1995). All of these changes reflected the growing size and complexity of financial markets.

The new regulatory responsibilities assigned to CRAs transformed them into a focal point for investors, borrowers, and other market participants. Financial actors recognized the official status of CRAs and adjusted their behavior according to their judgement. In this way, “credit rating agencies’ standard of creditworthiness... becomes a benchmark for other market actors” (Kruck 2011: 63). By providing a focal point for other actors in financial markets, the rating issued by CRAs served as a coordination mechanism. In technical-economic terms, CRAs “help fix the desired equilibrium in environments for which multiple equilibria would otherwise exist. In doing so, credit ratings help reduce fragility in the financial markets” (Boot, Milbourn, & Schmeits 2006: 82). As Sinclair (2008) also notes, the coordination effect of rating agencies “narrows the expectations of creditors and debtors to a well-understood or transparent set of

⁶ This criticism became more common following the financial crisis of 2008, as investors around the world relied on the high rating awarded to (as it turned out) risky collateralized-debt obligations. The Dodd-Frank Act approved in 2010 required the SEC and Government Accountability Office (GAO) to study the model of issuer-pays used by NRSROs and suggest alternatives to it.

norms, shared among all parties” (p. 15).

The incorporation of CRAs into the framework of financial regulation makes their rating more performative than evaluative, which means that credit rating not only describes the risk reflected in a specific security but also influences this risk. Downgrading the rating of a corporate bond can prompt its sale by investors, causing a decline in its price. This makes borrowing more expensive for the already-distressed corporation, making it harder to obtain further external finance to meet its obligations. In this sense credit rating can act as a self-fulfilling prophecy, something that economists already recognize in the context of sovereign debt (e.g. Cantor & Packer 1995; Gärtner & Griesbach 2012; Schumacher 2014).

The performative character of credit rating had important implications for the conflict between labor and capital. CRAs’ “standards of creditworthiness” and the set of norms they promote are far from neutral with respect to class struggle. They reflect the antagonistic nature of capitalist relations of production. Creditworthiness is a measure of the ability of a borrower to repay its debt. Rising labor costs can have a negative impact on the ability of corporations to service their debt. Wage cuts, on the other hand, can improve this ability by making resources available for future interest payments. This aspect of “creditworthiness” is taken into account in the methodology used to evaluate corporate debt. Thus, S&P states that labor relations are “an important focus” in its analysis, and that it takes into consideration any “sustainable cost advantage”, which also includes “lower and more flexible labor costs” (Standard & Poor’s 2013: 64). Labor and political unrest, on the other side, are considered a part of “a company’s vulnerability to exogenous factors” (Standard & Poor’s 2013: 62). Given their performativity, it is easier to understand the role credit ratings assigned by CRAs play in the class struggle between labor and capital. This coordinating function of credit ratings also contributes to

unifying the capitalist class around the institution of financial property, as suggested in Chapter Two. More specifically, credit ratings provide one of the mechanisms methods through which this unity was achieved.

The path to strategic bankruptcy

The growth of debt during the postwar era led to a sharp increase in the number of bankruptcies in the U.S., from around 10,000 per year in the mid-1940 to more than 200,000 per year in the late 1960s. This dramatic growth, driven by consumer bankruptcies, exposed many problem in the existing U.S. bankruptcy system. In 1970, Congress established a commission to study, analyze, and recommend changes in the existing laws in light of the recent developments. In 1973, the commission issued a report that eventually led to the Bankruptcy Reform Act of 1978, which was the first comprehensive revision of federal bankruptcy laws since 1938.

The legislative history of the Bankruptcy Reform Act of 1978 is complex and surrounded by controversy and intrigue. It involved various interest groups, including lawyers, judges, corporate managers, and financial institutions (for useful historical reviews see Klee 1979; Posner 1997; Skeel 2003). For the present research, however, what matters are the implications of the bankruptcy reform for labor relations in U.S. nonfinancial industries. Specifically, it is important to understand how the reform gave rise to the practice of *strategic bankruptcy*, i.e. the use of bankruptcy protection to achieve specific business purposes, which became common during the 1980s (Delaney 1992; Tavakolian 1995).

The spread of strategic bankruptcies was enabled by certain changes in the U.S. bankruptcy system enacted through the reform act of 1978. The first change was related to the management of a corporation filing for bankruptcy. Under Chapter X of the previous bankruptcy act, managers of a filing corporation were displaced by a court-appointed trustee, who was charged

with overseeing the reorganization process. To avoid this condition, managers of large corporations tended to prefer filing under chapter XI, which was originally designed for small businesses and closely held firms. Under this chapter management maintained its position, acting as the representative of the “debtor-in-possession”, and was also in charge of the reorganization plan (Skeel 2003).

The bankruptcy reform of 1978 created a new chapter 11, which consolidated several existing chapters. The new chapter 11 followed the previous chapter XI by assuming that the managers of a filing corporation would continue to operate the business unless the bankruptcy court decided otherwise. It also gave the existing management exclusive right to propose a reorganization plan (Skeel 2003). Some critics argue that chapter 11 gave too much control to managers and shareholders relative to creditors (e.g. LoPucki 1993). However, the American Bankers Association, which participated vigorously in the legislative process, also argued that chapter 11 should follow the path of chapter XI, which offered more flexible procedures and less involvement of the SEC (Posner 1997).

The second important change in the 1978 act had to do with the right to file for bankruptcy. Prior to 1978, the protection afforded by bankruptcy was available only to financially insolvent companies. Bankruptcy proceedings could be initiated by the debtor or its creditors, but in both cases the interested party had to prove that the debtor was indeed insolvent. The 1973 commission recommended the elimination of this requirement, with the goal of making it easier for creditors to force involuntary liquidation before dissipation of assets (Pasvogel 1980). The Reform Act of 1978 followed the recommendation by setting minimal restrictions on who can file for bankruptcy. However, this meant that solvent debtors could now also voluntarily file for bankruptcy and enjoy the protection it provided.

Taken together, these changes opened the path to the practice of *strategic bankruptcy*. Managers were not likely to voluntarily file for bankruptcy if it meant losing their jobs; the insolvency requirement would have made strategic bankruptcy much harder even if management's position was secured. Combining the two together made bankruptcy a viable business strategy.

The use of strategic bankruptcies in the context of labor relations, however, depended on another aspect of the law which involved the rejection of an *executory contract* if it places a heavy burden on the filing firm. Executory contracts are generally defined as contracts that are set to be fulfilled at a later date or have not yet been fully executed. The right to reject executory contracts under bankruptcy was not a novelty in 1978. Its historical roots go back at least to mid-nineteenth century England, and it was already incorporated in the U.S. Bankruptcy Act of 1898 (Delaney 1992). It was preserved in sections 365(a) and 1107 of the Bankruptcy Reform Act of 1978, which allowed a debtor-in-possession to unilaterally reject an existing executory contract if it placed a financial burden on the firm.

While the right to reject executory contracts was originally intended to allow trustees to cancel rental agreements, equipment leases and other contracts that dampen the chances of financial recovery, it could also be applied to labor contracts and collective bargaining agreements, which are clearly executory. Yet throughout most of the twentieth century, U.S. corporations filing for bankruptcy rarely used this right to reject collective bargaining agreements. Part of the reason was the National Labor Relations Act (NLRA) of 1935, which stated that collective bargaining agreements cannot be altered by one party without the consent of the other party, and must follow a complex set of procedures (Becker 1981). Since the provisions of NLRA are applicable not only to private employers but also to their "trustees in bankruptcy or receivers", there was a clash between the laws governing bankruptcy and labor relations (Countryman 1973).

Before the 1970s, only a handful of U.S. district courts decision had to consider this issue (Becker 1981). These cases were decided by the specific circumstances in each bankruptcy. However, the rapid growth in the number of bankruptcies made the conflict between bankruptcy laws and the NLRA much more visible.

The first important decision regarding collective agreements during bankruptcy was in the case of *Shopmen Local Union n. 455 v. Kevin Steel Products* in 1974 (Delaney 1992). Originally, the court allowed Kevin Steel to reject its labor contracts after filing for bankruptcy. The union appealed the decision to a district court and won, but this decision was later reversed by the Second Circuit Court of appeals. While allowing Kevin Steel to reject its collective bargaining agreement with the union, the court's decision also stated that bankruptcy courts should respect the policies of the labor laws. Unlike ordinary executory contracts that could be rejected as long as the debtor showed that such a rejection would potentially benefit the estate, the Kevin Steel decision stated that a bankruptcy court should apply a stricter standard when considering the rejection of collective agreements (Becker 1981). A short while after this decision, the Second Circuit reinforced its position in *Brotherhood of Railway, Airline & Steamship Clerks v. REA Express* (1975), which involved a similar clash between bankruptcy laws and the Railway Labor Act (RLA) that governed labor relations in railroads and airline industries. Here too the court approved the rejection of collective bargaining agreements, although under a more strict standard than the one applied in the *Kevin Steel* case.

Unions feared that these decisions would lead to a wholesale rejection of collective bargaining agreements by debtors-in-possession. In the hearings on the Bankruptcy Reform Act of 1978, union representatives explicitly requested congress to exclude collective bargaining agreements from the category of executory contracts that can be rejected by the debtor-in-possession. The

general counsel of the International Ladies' Garment Workers' Union (ILGWU) explained that giving debtors the power to nullify collective agreements puts workers at a clear disadvantage. He argued that to protect workers, it is necessary to prohibit such unilateral decisions, and argued that this required “simply inserting the words ‘except a collective bargaining agreement’ in line 3, page 63 of the bill” (U.S. Congress 1977: 945).

The final version of the act did include a clause excluding collective bargaining agreements from the provision regarding executory contracts – but only agreements that are subject to the Railway Labor Act (with certain exceptions). This exclusion had the opposite effect than what unions were hoping for, since it implied that all collective agreements not explicitly excluded can indeed be rejected as executory contracts in the case of bankruptcy. Indeed, this is the conclusion reached by the U.S. Supreme Court in *NLRB v. Bildisco & Bildisco* (1984).

As the U.S. economy entered into recession in the early 1980s, the number of corporate bankruptcies increased and with them the number of collective agreements rejected under the protection afforded by chapter 11 of the new bankruptcy code. Unions responded by challenging these rejections in court, and by 1983 the discussion on collective bargaining agreements under bankruptcy reached the Supreme Court in the case of the *NLRB v. Bildisco & Bildisco*. By that time, there were more than 30 cases upholding rejection of the collective bargaining agreement (for a full list see White 1983, footnote 3).

Bildisco was a New Jersey distributor of building supplies. In April 1979, the company signed a 3-year collective agreement with its workers, represented by the International Brotherhood of Teamsters. In the following months it encountered financial difficulties, and in January 1980 it stopped paying health and pension benefits and stopped remitting dues to the union. In April 1980 Bildisco filed for chapter 11 bankruptcy, and shortly after refused to pay the wage increases

set in the collective bargaining agreement. In December 1980 Bildisco officially petitioned the bankruptcy court to reject its collective bargaining agreement with the union.

The union filed a complaint with the National Labor Relations Board (NLRB), which decided in April 1981 that Bildisco engaged in an “unfair labor practice” by unilaterally changing the terms of the collective agreement without the approval of the bankruptcy court. The board petitioned the Third Circuit Court of Appeals to enforce its order, but the court held that a collective bargaining agreement is an executory contract subject to rejection by a debtor-in-possession under the new bankruptcy code (Brandow 1987).

In January 1983, the Supreme Court granted a writ to review the decision of the Third Circuit Court. It started hearing arguments on October 1983 and issued its decision on February 1984. The justices were unanimous in upholding the right of a debtor-in-possession to reject a collective bargaining agreement. The court noted that the Bankruptcy Reform Act of 1978 does exclude collective agreements subject to the Railway Labor Act, and concluded that the failure to grant a similar exemption in other cases indicates that Congress intended the right to reject executory contracts to apply to all collective agreements covered by the NLRA. The court was more evenly split on the question of unilaterally rejecting or modifying a collective agreement before the approval of the bankruptcy court, as was the case with Bildisco. However, here too a majority of five judges qualified Bildisco’s actions and rejected the claim that they constitute an “unfair labor practice”. The decision stated that opinion a debtor-in-possession must make reasonable efforts to negotiate with the union, but if such efforts fail it can unilaterally modify or reject the contract even before accepting the approval of the bankruptcy court, which can be obtained after the fact. The minority opinion, in contrast, held that such ability “seriously undermines the goals of the NLRA” (Belous 1985).

Following the decision in *NLRB v. Bildisco & Bildisco*, unions pressured congress to revise the bankruptcy act, declaring it to be their “top lobbying priority” for 1984 (Keller 1984). Congress responded by passing the Bankruptcy Amendments and Federal Judgeship Act of 1984, which imposed restrictions on the ability of companies in bankruptcy to reject a collective agreement (section 1113). Two years later, the LTV Corporation filed for chapter 11 in what was the largest bankruptcy in U.S. history to that point, and immediately ceased the payment of retiree health benefits covering some 70,000 retirees. Congress acted again by adding provisions prohibiting the elimination of retiree health, life insurance and disability benefits in what became section 1114 of the Bankruptcy Code (Ceccotti 2007).

Both sections did little to eliminate labor targeted bankruptcies, which became more frequent in the late 1980s. In April 1990, the *New York Times* noted that “bankruptcy courts have become forums for airing product liability problems and labor disputes” (Labaton 1990). Three years later, Larry Black of the UK based *The Independent* wrote that in corporate America, bankruptcy through chapter 11 “is fast becoming a way of life” (Black 1993).

The impact of strategic bankruptcies on labor relations in the U.S. was not limited only to corporations filing for bankruptcy. The threat posed by bankruptcy and rejection of collective agreements strengthen the bargaining position of management, made its threats more credible, and helped transformed corporate debt into a strategic tool against organized labor. A report by the Congressional Research Services, published less than a year after the *NLRB v. Bildisco & Bildisco* decision, emphasized this likely outcome. The report noted that “the potential for declaring bankruptcy could have a significant effect on labor-management relations... in weak economic periods the threat of bankruptcy could improve management's bargaining position even if no Chapter 11 case is actually filed” (Belous 1985: 6). I will return to the topic of

strategic bankruptcy in the section on the airline industry, where this practice became very common during the 1980s, but it should be kept in mind when considering the use of corporate debt as a strategic tool in the auto and steel industries as well.

Conclusions

Existing approaches in the financialization literature tend to neglect the historical development of the class struggle and its role in the financialization of the U.S. economy. Instead, they focus on the economic problems of the 1970s as providing the motivation for the shift toward finance. From this perspective, the impact of financialization on income inequality appears at most as an unintended consequence. The alternative approach presented in this chapter views these problems as the outcome of successful struggles waged by the working classes and organized labor since the late 1960s. Viewed from this perspective, it is clear that rising income inequality was not an unintended side-effect of financialization, but rather its very *raison d'être*.

In the late 1960s, the successful mobilization of workers prevented management from making them bear the brunt of declining profits due to foreign competition. American corporations were in a very different position in the late 1970s. After a decade of weak growth, inflationary spirals and increased international competition, corporate managers were willing to go much further and make greater sacrifices to break the power of organized labor.

The political environment in the late 1970s was also very different, with large businesses and financial firms exerting much more influence on policy-making and legislation processes. When Nixon faced a problem of rising unemployment and high inflation a decade earlier, he was determined to avoid a recession that might cost him the election. Members of the Council of Economic Advisers (CEA) were “surprised and unhappy” to learn that Nixon assured the AFL-CIO that the fight against inflation would not come at the expense of employment (DeLong

1997: 261). Evidence from the Nixon tapes reveal how he pressured Arthur Burns, whom he appointed chairman of the Federal Reserve, to engage in expansionary monetary policies in the months leading to the 1972 election (Abrams 2006).

The pressures to appoint Paul Volcker as head of the Federal Reserve ensured that this scenario would not repeat itself. Already in their first meeting, Volcker told Carter that he would insist on the independence of the central bank (Lindsey, Orphanides, & Rasche 2005). This independence mainly meant that the Federal Reserve was “less accountable to the government and more accountable to financial markets and those who operate in them” (Epstein 2001: 7-8). The results of this “independence” – the Volcker Shock and the economic recession that followed – contributed to Carter’s defeat in the 1980 election.

Thus, when organized labor mobilized again in the beginning of the 1980s, workers found themselves in a much tougher position. Throughout the decade, U.S. NFCs relied much more on debt to finance their operations. In the first half of the 1970s, their total debt (including loans and debt securities) grew by 22% in real terms, and in the second half it expended by another 45%, passing the \$1.5 trillion mark in 1980. This mountain of debt could not be overcome through strikes or negotiations with management. When the Federal Reserve started to tighten its monetary policy and interest rates rose sharply, corporate debt was transformed into an effective “negotiation tool” to extract concessions from workers.

Chapter 4. Corporate Debt as Class Strategy

Introduction

The previous chapter examined the historical roots of financialization from a class perspective. It showed that the problems to which financialization provided a “solution” were closely related to the escalating conflicts between workers and employers since the late 1960s, and that the war on inflation can be viewed as a form of class warfare, as it was calculated to bring inflation under control by holding down wages. I suggested that the Volcker Shock was related to a broader shift in property relations that prioritized the interests of holders of financial assets. The present chapter turns to explore more closely the relationship between financialization and income inequality by focusing on the use of corporate debt as a *negotiation tool* in the context of collective bargaining processes in U.S. NFCs in the early 1980s.

To my knowledge, there are no empirical studies that focus specifically on the impact of rising corporate debt on income inequality. However, both post-Keynesians and sociologists point to this possibility. Post-Keynesians argue that high interest expenses can “induce management to recover this drain of funds... by raising prices or forcing down unit labor costs” (Hein 2015: 927), and that the wave of leveraged buyouts in the 1980s have “loaded firms up with debt, thereby pre-empting the income claims of workers” (Palley 2013: 50). Sociologists suggest that “the shift from equity to debt financing moved capital claims on value added to a position equivalent to or even prior to those of labour” (Tomaskovic-Devey, Lin, & Meyers 2015: 7), and that firms with high debts “will likely have less scope for wage growth” (Alvarez 2015: 461).

But why should these be the outcomes of high corporate debt? After all, there is no inherent reason why interest payments should come at the expense of wages rather than profit.

Sociologists and post-Keynesians suggest that high corporate debt can undermine the bargaining

power of organized labor. However, economic studies on corporate capital structure show that strong unions can weaken the influence of debt on wages (e.g. Garvey & Gaston 2009), and that strong unions can also limit the amount of debt issued by the corporation (e.g. Chen, Kacperczyk, & Ortiz-Molina 2011; Woods, Tan, and Faff 2019). Some post-Keynesians also find that in countries with high union membership, a smaller share of the national income is paid as interest and dividends (e.g. Jayadev & Epstein 2007), while sociologists show that the impact of financialization on income inequality is weaker in countries with higher union density (Kus 2012). Thus, it is possible that the decline in the power of labor was more of a necessary condition than an outcome of financialization and rising debt.

In any case, to assume that financialization automatically weakens labor is to cast workers in a passive role, in which they quietly adjust to changing conditions that are above and beyond their control. This implied passivity is a major limitation even in Marxist accounts of the shift toward finance (e.g. Sweezy & Magdoff 1972, 1987; Lapavistas 2014). As Cleaver (2017) points out, “class struggle, completely absent in the narratives of neoliberals and neo-Keynesians, rarely enters Marxist analysis except in calls for resistance” (p. 143). But as history shows, such fundamental changes in the structure of capitalist economies are not likely to pass without a struggle, unless workers were already defeated or never organized to begin with.

The class struggle framework employed in this dissertation addresses this issue by reminding us that the quantitative relationship between economic categories such as debt and wages hides behind it a social relation between people, and evolves and changes with the development of these relations themselves. Rather than a cause or an outcome of the declining power of labor, it suggests that rising corporate debt should be understood as a constitutive element within the historical development of the class struggle. The previous chapter reexamined the problems in

the U.S. economy during the 1970s from within the dynamic of the conflict between workers and capitalists. The present chapter investigates how the “solution” provided by financialization helped shape this class battlefield.

Corporate debt since the 1950s

In the literature of financialization, the growth of corporate debt is usually viewed as an outcome of the SV approach, which recommends substituting debt for equity as a source of external finance (e.g. Lazonick & O'Sullivan 2000; Fligstein 2005; Dobbin & Jung 2010). However, like many other trends associated with financialization, corporate debt was on the rise long before the transformation in the governance of American corporations, and continued to grow throughout the postwar era.⁷ In 1955, the total debt of U.S. nonfinancial corporations (NFCs) was around 23% of GDP. By the early 1970s it was almost 33% (figure 4.1).

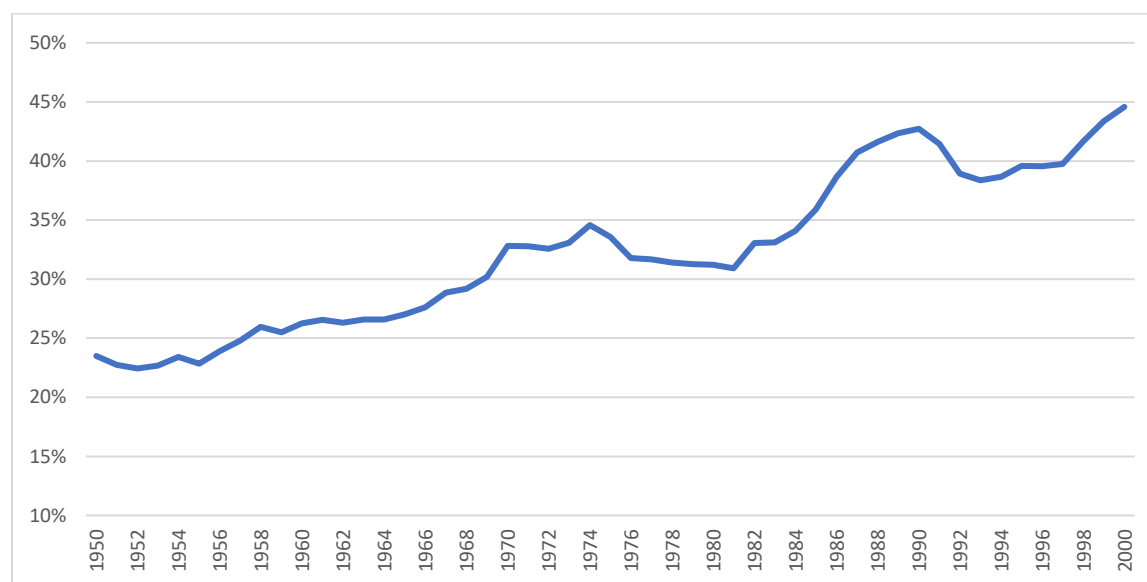


Figure 4.1 Nonfinancial corporate debt as % of U.S. GDP

Source: Own calculations based on data from the Federal Reserve Bank of St. Louis

At least since the early 1960s, U.S. NFCs have been relying more heavily on debt than equity as

⁷ This holds true also for the stock-based compensation to top managers. While it is often associated with the adoption of the SV approach, already in the mid-1970s Jensen and Meckling (1976) note that the use of stock-based compensation “seems to be a commonly observed phenomenon” (p. 353).

a source of external finance. As a result, their debt-to-equity (D/E) ratio, calculated as total liabilities over total equity, rose from 0.78 in 1960 to 1.22 in 1970. At the time of the Volcker Shock in 1979, the average D/E ratio for nonfinancial industries in the U.S. was around 1.52 (figure 4.2). The composition of corporate debt also changed during the period. In 1955, short-term corporate debt was around 25% of long-term corporate debt. By 1970 it was higher than 35%. At the end of 1979, the short-term debt of U.S. NFCs was almost 42% of long-term debt.

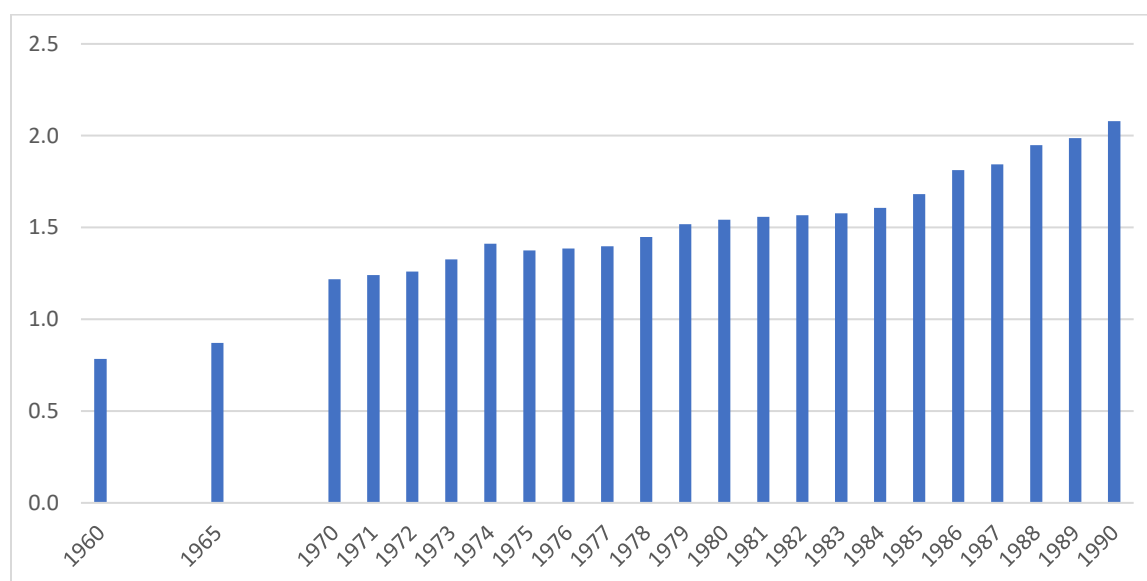


Figure 4.2 Debt-to-equity ratio, U.S. nonfinancial corporate businesses

Source: Own calculation based on data from the Corporate Income Tax Returns reports, IRS

As the economic problems of the 1970s persisted and interest rates started to rise, the heavy debts accumulated by NFCs became much riskier. By the mid-1970s, the financial media were sounding the alarm bells, calling this “mountain of debt” a serious threat to the economy (Hopper 1975) and discussing whether debt in the U.S. was “out of control” (U.S. News & World Report 1975). Reviewing these trends before the Joint Economic Committee of the U.S. Congress, Federal Reserve Chairman Arthur Burns (1975) warned that “large businesses no longer have the resiliency they once had to resist economic and financial adversity” (p. 19). By the end of the decade corporate debt expended by another 45% in real terms, passing \$1.5 trillion in 1980. A

study conducted by the investment bank Salomon Brothers warned that restoring corporate debt to normal levels will be an “unprecedented and perhaps unachievable challenge” (quoted in Rowe 1980).

Inflation, which is considered one of the central economic problems of the 1970s, actually helped mitigate the problem of excessive corporate debt: since inflation decreases the purchasing power of each dollar, thus eroding the real value of debts, it is quite beneficial for debtors. For the very same reason, inflation was a cause of concern for creditors, for whom these very same debts represent financial assets rather than liabilities. As mainstream economists also recognize, inflation redistributes income from creditors to debtors (e.g. Bach & Ando 1957; Shiller 1997). By the end of the decade, these inflationary risks drove many investors away from the corporate bond market. In August 1980, the *Washington Post* reported that investors “are skeptical about investing their money in long-term securities”, forcing NFCs to rely more heavily on banks, commercial paper markets and other sources of short-term finance (Rowe 1980).

It was under these adverse conditions that the Federal Reserve, headed by the newly appointed Paul Volcker, made a sharp turn in its monetary policy with the goal of “breaking the back” of inflation once and for all. Raising interest rates to unprecedented levels made it much harder for businesses to reorganize their debt structure by replacing their short-term debt with long-term obligation. In other words, refinancing debt became much more difficult due to the high cost of borrowing. As a study from Salomon Brothers noted, “what was 20 years ago a routine task of restoring balance sheets in order to participate in the subsequent economic expansion has become confounded immeasurably” (quoted in PR Newswire 1980).

Despite these known problems, the Federal Reserve stuck to its guns, as Volcker vowed it would. If the standard response of central banks in the face of a potential recession is to lower interest

rates, a move that is supposed to stimulate the economy by encouraging consumers and businesses to borrow money for spending or investments, the Federal Reserve under Volcker did the exact opposite. As consumer credit became more expensive, aggregate demand dropped sharply. The first industries to take the hit were auto manufacturing and residential construction, which traditionally relied on the ability of consumers to obtain credit in the form of mortgages and car loans. When the decline in demand continued, the crisis spread from consumer goods to capital goods industries, as producers reduced their orders for machines and equipment. As the Volcker Shock drove the U.S. economy into deeper and deeper into a recession, unions faced increasing pressures to provide wage and benefit concessions in their collective agreements.

Corporate debt and concession bargaining

The economic recessions of the early 1980s gave rise to the novel practice of *concession bargaining* in many U.S. industries. If conventional bargaining usually involved compromises from both sides, with concession bargaining these came almost entirely from the side of labor and were much more extreme (Capelli 1983; Wever 1983; Moody 1988; Bell 1995; Chaison 2012). Of course, unions made sporadic concessions during the 1960s and 1970s as well. However, with the recessions of the early 1980s, concession bargaining became more and more frequent, and within a few years it spread to almost all American industries, from production workers in steelmakers to service employees in the hospitality business (Moody 1988).

It was during this period of concession bargaining that corporate debt became an effective negotiation tool to extract wage and benefit concessions from unionized workers. High levels of corporate debt increased the credibility of management's threats and made union leaders much more reserved about active steps that might increase the likelihood of bankruptcy. The quantitative relationship between corporate debt and wages found by financial economists in the

early 1990s was the contingent outcome of these struggle, abstracted from the social relations in which it came into being. To analyze this relationship outside of its historical context is to fetishize corporate debt as an autonomous power that can shape capitalist social relations through its own volition. To avoid such mistakes it is important to remember that the relationship between corporate debt and wages does not determine the social relations between workers, managers, shareholders, and creditors; it simply expresses these relations in economic terms.

The following sections trace the strategic use of corporate debt in in three industries: auto, steel, and airlines. The investigation focuses mainly on the role of corporate debt in collective bargaining processes during the economic recessions of the early the 1980s. As we will see, while the recession was felt across the board, each of these industries was facing its own unique problems that were intertwined with other important developments during the period, including competitive pressures from foreign manufacturers, deregulation, and overcapacity. Nevertheless, in all three industries it is possible to identify a similar pattern, in which the strategic use of corporate debt first emerges in highly indebted firms that were facing possible bankruptcy, but quickly spreads to other NFCs that were in much better conditions. These firms faced no danger of collapse, but took advantage of the challenging market conditions and their high level of debt to pressure workers into concessions. As the president of the International Association of Machinists told the *New York Time* in late 1981, employers seek to capitalize unfairly on the recession, while many unions enter into negotiations “without doing the tough, methodical work it takes to find out whether an employer is as bad off as he says he is” (quoted in Serrin 1981).

The Auto Industry

Although there were instances of wage and benefit concessions before those negotiated in the auto industry, the high visibility of negotiation between the United Auto Workers (UAW) and

the large auto manufacturers set the tone for the first wave of concession bargaining in the U.S. economy. Traditionally, the collective agreements negotiated by the “Big Three” – General Motors (GM), Ford, and Chrysler - provided the backbone of the entire pattern structure of industrial collective bargaining in the economy. Thus, the impact of the concessions in the auto industry was felt across the manufacturing sector (Moody 1988; Chaison 2012).

Through most of the postwar era, the global domination of the U.S. auto industry was practically unchallenged. In the mid-1950s, American manufacturers produced more than 70% of motor vehicles sold worldwide (Motor Vehicle Manufacturers Association 1956). At home, investments in highway construction alongside energy policies that kept gasoline prices artificially low created a protected environment where manufacturers prospered by catering to the demand for large cars, which were more profitable than smaller vehicles (U.S. Department of Transportation 1981).

During this period, the U.S. auto industry was a trendsetter in collective bargaining for other American manufacturers. Many features that later became common across the U.S. economy were first negotiated between the UAW and the “Big Three”, which controlled more than 80% of the market. These innovations included multi-year contracts with cost-of-living-adjustments (COLA), supplementary unemployment benefits, quality of working life programs, and pattern bargaining (Katz, MacDuffie, & Pil 2014).

The situation started to change during the 1960s, as foreign manufacturers increasingly penetrated domestic markets. While imports accounted for less than 5% of U.S. passenger car sales in 1960, by the end of the decade their share rose to about 15% (Ingrassia 2010). At the same time, new government regulations related to safety and air pollution required auto manufacturers to increase their level of capital investment.

The oil crisis of 1973 dealt a strong blow to the U.S. auto industry, as rising fuel prices drove consumers to smaller, more fuel efficient cars. The share of imported cars in the U.S. market rose from 15% in 1973 to 27%, in 1981, while the share of U.S. auto manufacturers in the global production of motor vehicle dropped from 32% to 21% (Bass 1985; Williamson 2001). In 1980, the number of cars produced in Japan surpassed the production of cars in the U.S. for the first time. These developments, coupled with managerial errors and misreading of the market, almost led to the collapse of Chrysler, the tenth largest industrial corporation in the U.S. at the time.

Crisis in Chrysler

Among the Big-Three, Chrysler was traditionally the most leveraged, and relied on debt-financing more heavily than GM or Ford. Like most of the U.S. manufacturing sector, the auto industry emerged from WWII almost debt-free. In the early 1950s, GM, Ford, and Chrysler still carried a minimal level of debt on their books. But by 1957, D/E ratio for Chrysler reached 0.34, compared with 0.05 for GM and 0.09 for Ford (U.S. Congress 1979b).⁸ During the economic expansion of 1960s, long-term obligations carried by Chrysler more than tripled from \$250 million in 1960 to \$791 million in 1970 (Hyde 2003). Between 1971 and 1975, Chrysler's total debt grew by 25% to \$1.53 billion, while its equity increased by only 7.4%. When the interest rate in the U.S. started to rise, this heavy debt burden turned into a cash flow shortage, as interest expenses more than doubled from \$53 million in 1974 to \$130 million in 1978 (Glasberg 1989). At the same time, its share of the domestic market declined from 16.1% in 1970 to 10.1% in

⁸ The growth of Chrysler's corporate debt was possibly related to its large distribution network. In the late 1950s, Chrysler's passenger car divisions had nearly the same number of total dealer franchises as GM, even though its total car sales were only one-fourth the sales of GM. In 1957 Chrysler also acquired its first substantial stake in an overseas subsidiary (Simca), which did not yield the anticipated profits. (U.S. Congress 1979b: 506). Simca, founded in 1934 as a French subsidiary of Fiat, acquired a few years earlier (1954) Ford SAF, the French subsidiary of Ford.

1979, as consumers increasingly switched to more fuel-efficient models (Hyde 2003).

Despite its declining market share and rising interest expenses, Chrysler continued to distribute quarterly dividends to its shareholders through the period. Although it reported an annual loss each year since 1974, in mid-1977 its board decided to increase the quarterly dividend to from 15 to 25 cents per share. A few months later the company reported a drop of 55% in its quarterly earnings (Washington Post 1977). Chrysler continued to distribute a quarterly dividend even after reporting a net annual loss of \$163 million for 1977 (Washington Post 1978). In the first quarter of 1978 Chrysler lost \$120 million, while GM and Ford reported robust quarterly profits (Egan 1978). In the third quarter of 1978 Chrysler reported a quarterly loss of \$458 million – the biggest in its history. Only then did the board decide to reduce the quarterly dividend from 25 cents to 10 cents per share (Woutat 1978). Chrysler reported an annual loss of \$205 million for 1978, compared with an annual profit of \$3.5 billion reported by GM and \$1.5 billion by Ford (Bass 1985). Some financial experts argue that Chrysler could have avoided significant financial difficulties if it had reduced its dividends in the early 1970s (Bickley 2008).

As losses continued to mount in 1979, Chrysler was forced to turn to the federal government for financial assistance. By that time the firm had accumulated \$4.75 billion in debt, and its long list of creditors included more than 400 banks and insurance firms, which were no longer willing to provide it with additional loans (Glasberg 1989). Lee Iacocca, who was brought in as CEO in late 1978, later complained that “our bankers must have been asleep at the wheel. None of them ever seemed to wonder about the health of the company” (Iacocca 1984: 268).

Chrysler’s financial distress set the tone for its negotiations with UAW. Management insisted that to save the firm from liquidation, workers must make substantial concessions. Fearing a possible bankruptcy, the UAW signed a new collective agreement in October 1979 that provided

Chrysler with wage and benefit concessions that amounted to an annual sum of \$203 million (Holmes & Rusonik 1991). UAW also agreed to allow Chrysler to defer \$200 million in pension plan funding (Jones 1979). Although the Canadian branch of the UAW (CUAW) opposed the concessions, it reluctantly accepted them to maintain contract uniformity with workers in the U.S. (Schiavone 2008). The agreement between UAW and Chrysler broke the wage parity with Ford and GM for the first time in more than 40 years.

While UAW was ratifying these concessions, the U.S. Congress started its hearings on the *Chrysler Corporation Loan Guarantee Act*, designed to assist the ailing auto manufacturer. In the congressional hearings, Iacocca put much of the blame for Chrysler's difficulties on government regulation, oil prices, and labor costs. He argued that foreign manufacturers are able to compete "by virtue of their lower wage rates" (U.S. Congress 1979b: 89). Of course, GM and Ford were facing the same government regulations, oil prices, and labor costs as Chrysler, and still managed to turn a handsome profit in 1978 and 1979. Nevertheless, Congress was especially attuned to the labor-related grievances expressed by Iacocca. Representative Richard Kelly (R-Florida), for example, argued that Chrysler's workers make twice as much as the average American worker, and blamed UAW president Douglas Fraser of "trying to rip off the people in this country" (U.S. Congress 1979b: 295).⁹ Representative Norman D. Shumway (R-California) expressed his concerns that after receiving the federal loan, Chrysler might use it to award wages and benefits to its employees, which could easily be deemed to be inflationary, adding that the loan must include "some assurance that this kind of settlement is not going to result" (U.S. Congress 1979b: 171). Iacocca replied that the firm "would appreciate any kind of help" that

⁹ Ironically, only a year later Representative Kelly was convicted for taking bribe in the Abscam scandal and was sentenced to 13 months in prison.

Congress could provide in preventing such a scenario and keeping the UAW in check. Thus, despite the givebacks already provided by UAW, Congress demanded further wage concessions before approving an emergency loan. In early 1980, UAW and Chrysler reopened the collective agreement signed only a few months earlier. UAW agreed to additional concessions for the sum of \$230 million, while nonunionized workers “contributed” \$125 million (Schiavone 2008).

By insisting on further wage concessions as a condition for a federal loan, Congress sided with management in its negotiation with UAW. This might seem like a reasonable demand, given that high labor costs can make it more difficult for the firm to repay its debt. However, a year later, when the Canadian government provided Chrysler with \$250 million (Canadian) in an emergency loan, it actually made the opposite demand: the loan required Chrysler to avoid closing any existing facility without approval of the minister of industry, to maintain a predetermined level of employment, and to invest approximately \$1 billion (Canadian) in Canada by 1985. While the U.S. Congress insisted on wage cuts as a condition for Federal assistance, the Canadian government demanded job security for workers. As one Chrysler executive noted, “it sure is different in Canada... Over here the government lines up with the goddamned union” (quoted in White 1987: 168). As Holmes and Rasunick (1991) note, “the more general ideological and political differences between the USA and Canada were reflected in the way that the governments of the two countries responded to Chrysler's request” (p. 22).

Despite the federal bailout, things did not improve much for Chrysler in the following months: between January and September of 1980 the company reported a net loss of \$1.48 billion (Darst 1980), and by the end of the year its management demanded that UAW reopen contract negotiations yet again and agree to a 22-month wage-freeze. This time Ford and GM made clear that they would ask the UAW for similar concessions (Associated Press 1980). A Ford

spokesman said that the company is watching the negotiations between Chrysler and UAW “with a good deal of interest”, while GM Chairman Roger Smith explained that “you cannot have a two-tier industry” (quoted in Moody 1988: 153).

In the beginning of 1981 Chrysler’s workers approved a third round of concessions, estimated at \$622 million (Holmes & Rasunick 1991). Following the agreement, President of the UAW Douglas Fraser said that the union is "anticipating that everybody will be knocking at the door now” (Townsend 1981). He was not wrong. Following the approval, GM and Ford turned to the UAW and demanded similar concessions.

Pressures from GM and Ford

Although Chrysler was traditionally more leveraged than other auto manufacturers, GM and Ford were quickly catching up. In the late-1960s, the D/E ratio for the Big-Three vehicle was around 0.5. By the mid-1970 it was hovering above 0.8, and when the recession hit the U.S. economy it bounced to more than 1.2 (figure 4.3). A report from the U.S. Department of Transportation (1981) concluded that auto manufacturers would find it difficult to remain competitive while servicing their debt, and that “interest costs and the costs of repaying debt alone could raise the costs of a domestic vehicle by several hundred dollars during the next few years” (p. 70).

Between 1978 and 1982 alone, the long-term debt of U.S. auto manufacturers increased by 170%. A report from the U.S. Department of Commerce (1984) found that between 1979 and 1982, domestic auto manufacturers financed their operations and investments “through massive increases in debt, heavy erosions of working capital and the sale of non-automotive assets. In the process... debt became a major part of U.S. car makers' financial structures” (p. 3).

Unlike Chrysler, GM and Ford continued to report strong profits throughout the 1970s. Between 1975 and 1979, GM made an aggregated profit of \$13.9 billion, while Ford “settled” for a net profit of \$5.7 billion (Bass 1985). However, as the oil crisis of 1979 started taking its toll, both firms also started losing money at a fast pace. Ford lost \$1.23 in the first nine months of 1980, while its long-term debt climbed to \$5.5 billion (Darst 1980). GM, which reported a net loss of \$824 million for the same period, issued \$1.3 billion in long-term debt during the year (Wall Street Journal 1981a). In 1981, GM borrowed another \$2 billion, bringing its long-term debt to \$3.8 billion, double the \$1.9 billion it had a year before (Wall Street Journal 1982a).

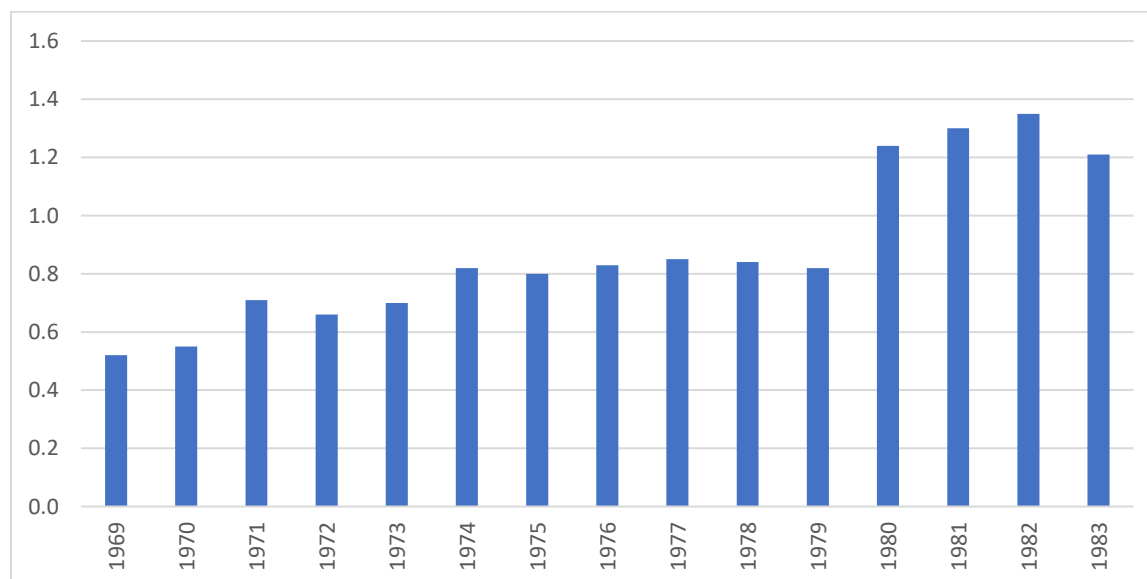


Figure 4.3 Debt-to-equity ratio for GM, Ford, and Chrysler

Source: U.S. Department of Commerce 1985a: 65

With their debt rising and sales dropping, Ford and GM faced increased scrutiny from credit rating agencies (CRAs). By the end of 1980, both Moody’s and S&P lowered the rating on the debt issued by Ford, explaining that although it could still repay its debts, the auto manufacturer had become significantly more vulnerable financially (Behr 1980). In 1981, Moody’s and S&P downgraded the debt issued by GM, citing a “heightened concern” about the future recovery of the auto industry (Wall Street Journal 1981b: 14).

As GM and Ford amassed more and more debt, UAW faced increased pressures to provide the two with concessions similar to those made for Chrysler (Holusha 1981). In March 1981, the GM and Ford councils within the UAW rejected a demand to reopen their collective agreements. By the end of the year the decision was reversed, and in early 1982, UAW agreed to sweeping concessions at Ford, estimated to be worth \$1 billion over a period of 30 months (Peterson 1982). The concessions included the termination of paid personal holidays, eliminating the 3% annual improvement factor that had existed since in 1948, and deferring COLAs and pension increases. Two months later GM negotiated a similar deal, which saved it around \$3 billion over a period of 29 months (Moody 1988). When these contracts expired at the end of 1982, the UAW negotiated a new two-year agreement that continued the wage and benefits freeze in both GM and Ford (Holmes & Rasunick 1991).

Alongside the demand for concessions, auto manufacturers also used their high levels of debt to justify closing factories only to reopen them somewhere else as a non-union shop. The UAW and other unions complained that financially strapped companies increasingly resorted to such “union-busting” tactics, and UAW counsel Jay Whitman argued that “you have heavily leveraged companies that want to dump some of their debt, so they choose to play musical chairs” (quoted in Engel 1983: 19). But despite all of their financial distress, throughout the recessions of the early 1980s auto manufacturers continued to distribute billions of dollars in dividends to their shareholders, even when reporting record losses (figure 4.4).

Following the negotiations at Ford and GM, concessionary bargaining quickly spread to other firms and industries. By the end of 1982, major concessions had been negotiated in airlines, meatpacking, agricultural implements, trucking, grocery, rubber, and smaller steel firms (Ruben 1983). Concessions were also made in profitable companies such as Kroger, Iowa Beef, Gulf Oil,

Texaco, Caterpillar Tractor, and UPS. In a survey conducted by Business Week among 400 CEOs, almost 20% stated that "although we don't need concessions, we are taking advantage of the bargaining climate to ask for them" (quoted in Moody 1988: 168).

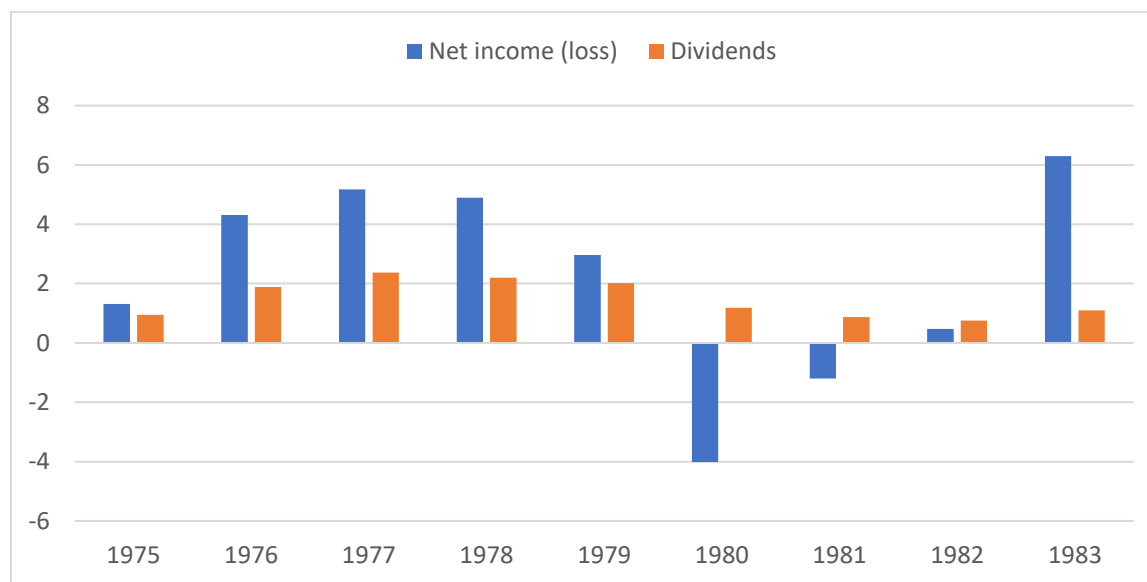


Figure 4.4 Net income (loss) and dividends for GM, Ford, and Chrysler, billion \$
Source: U.S. Department of Commerce (1984: 76)

No doubt, the first wave of concession bargaining overlapped with a period of economic slowdown and rising unemployment. Reflecting on these changes, Chrysler's Vice President of Industrial Relations Thomas Miner (1983) explained that during the more prosperous years of the postwar era, companies "were chiefly concerned with short term profits at the expense of long term financial stability" (p. 982). The "good life" came to an end in 1979 when the Federal Reserve raised the interest rate to unprecedented heights, leading to a severe recession in 1980, which "caused managements to take a firm position with unions" (Miner 1983: 985). However, as the previous chapter showed, this was the explicit goal of the Volcker Shock and the monetary policy adopted by the Federal Reserve. Like Hernán Cortés burning his own ships to force his men to fight or die, raising the interest rate was meant to prevent management from retreating into the old pattern of "wage-price spiral". Miner's testimony and the concrete outcome of the

Volcker Shock show that this strategy was quite effective.

Within these development, corporate debt played an important role in convincing unions of the necessity of concessions. Miner (1983) argued that with the economic recession of the early 1980s, unions started to act “in a much more responsible manner by recognizing that it is in their long-term interest as well as in management's that the company survive” (p. 985). However, Miner also noted that GM and Ford, unlike Chrysler, were never in any real danger of bankruptcy. If the UAW accepted that wage concessions were necessary to “save” these firms, their heavy debt burden was likely an important factor in this decision. Indeed, one of unions’ long-standing demands was that management “open up the books” to provide evidence of the financial distress the firm is facing. According to the NLRB, a well-settled principle is that “when an employer asserts financial hardship as a basis for its bargaining position, the union is entitled to an inspection of the company’s books to verify the employer’s economic situation (National Labor Relations Board 1988: 305). While management strongly opposed this demand during the postwar era, many reversed their position in the early 1980s (Wechtel 2013). With huge amounts of debt on their books, it is not hard to understand this change of hearts. If firms would have relied more on equity than debt to finance their operations, their balance sheets would have offered much less convincing evidence for the need for concessions.

Unlike the first wave of concessions during the recessions of 1980-1982, the second wave of concession bargaining started when the U.S. economy was actually recovering, and unemployment was in decline. Despite these positive signs, in 1983 about 20% of private industry workers covered by major collective bargaining settlements (those affecting 1,000 workers or more) had their wages cut (Ruben 1984). The USW also caved and granted the seven major steel firms concessions worth around \$3 billion, while major concessions were also being

made in airline transportation and meat processing. In addition, concessions related to working conditions, work rules, production standards and other aspects of the workplace became increasingly common. Despite the recovery, these concessions continued in the following years, and the notion that concessions were a temporary phenomenon visited only on ailing industries and firms “was no longer tenable” (Moody 1988: 169).

The Steel Industry

In December 1982, Paul Rusen of the United Steelworkers (USW) announced that the steelmaker Wheeling-Pittsburgh would soon run out of money. Rusen, chief negotiator and president of USW’s District 23, stated that without wage concessions from its workers, Wheeling would soon be in violation of its loan agreements, allowing creditors to move in and demand payment.

“There is no other way”, Rusen concluded (quoted in Associated Press 1982a).

This was not the first time that Wheeling-Pittsburgh - the eighth-largest U.S. steelmaker at the time – asked its workers to make sacrifices to ease its financial burden. Already in 1980, Wheeling’s workers agreed to cuts in their incentive pay at the request of management. In April 1982, workers agreed to a reduction of \$1.65 in labor costs (including wages, benefits, pension, and payroll taxes), which saved Wheeling \$35 million over the following 19 months. At that time, the *Washington Post* reported that “the latest givebacks are designed to help the company retire nearly \$360 million in long-term debt incurred in a modernization program” (Brown 1982).

Wheeling’s financial distress was related to its capital investment program, which was financed mainly through debt. As a result, its long-term debt more than doubled between 1979 and 1982, rising from \$170 million to \$360 million (Thompson 1982b). In 1982 Wheeling-Pittsburgh reported a net loss of \$58.8 million, compared with a net profit of \$60.1 million in 1981 (Thompson 1982a; Sommer 1983). Faced with these conditions, the USW agreed to sign a new

collective agreement that broke with the Basic Steel Agreement, a master contract between the USW and large steelmakers that imposed standard wages, benefits, and conditions across the industry. Wheeling's new contract reduced its labor costs to \$18.6 per-hour, compared with \$25 per-hour set in the Basic Steel Agreement signed in 1980. The *Washington Post* estimated that together with the April givebacks, the total concessions made by Wheeling's workers in 1983 were worth \$132 million to the ailing steelmaker (Auerbach 1983a).

Although Wheeling-Pittsburgh was more financially distressed than other steelmakers, the growth of corporate debt was an industry-wide trend. Since the mid-1960s, major steelmakers in the U.S. increasingly relied on debt to finance their operations, replace worn down equipment and maintain their facilities in working condition. As a result, D/E ratio for large U.S. steelmakers (operating integrated mills) rose from 0.18 in 1960 to 0.67 in 1970 (figure 4.5). D/E remained between 0.45 and 0.65 through most of the decade, but jump to 0.89 in 1982, passing 1.0 in the following year.

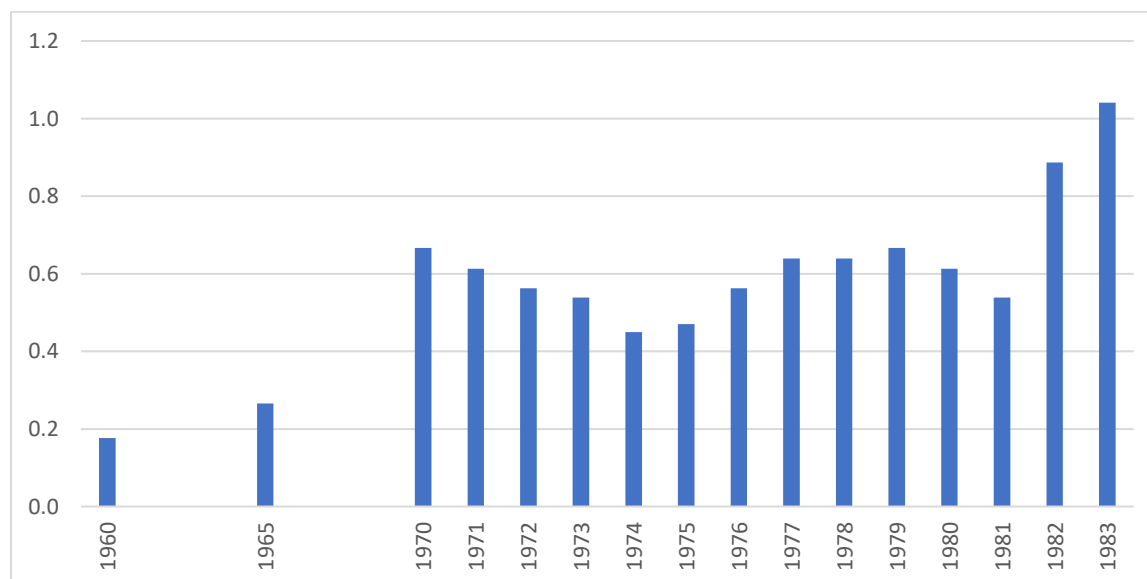


Figure 4.5 Debt-to-equity ratio in the steel industry, integrated mills

Source: Own Calculation Based on Data from U.S Department of Commerce 1985: 59

When the U.S. economy entered into the recessions of the early 1980s, the financial situation of

the steel industry quickly turned from bad to worse. In 1982, total sales for the industry declined by 13.9%, and long-term debt jumped by another 60% to \$15.1 billion. The aggregated net loss of U.S. steelmaker amounted to \$3.2 billion, compared with an aggregated net profit of \$2.6 billion in 1981. Following the lead of the auto industry, steelmakers turned to their workers to demand wage and benefit concessions.

The rise and fall of American steel

As the only major steel industry not harmed in WWII, U.S. steelmakers dominated the global market in the early postwar era. In 1946, the U.S. produced more than half of the global output of raw steel. Throughout the postwar era, large U.S. steelmakers invested very little in technological innovation, and lagged behind foreign competitors in adopting newer and more efficient production techniques. The oligopolistic structure of the American steel industry - eight steelmakers accounted for more than 75% of the output, with U.S. Steel controlling more than 25% of the market – ensured high profits through implicit price coordination, with changes in price usually announced by U.S. Steel or Bethlehem and then followed by the rest of the industry (Rogers 2009). This situation was hardly conducive to investment (D’Costa 1999).

After Japan, Europe, and the Soviet Union rebuilt their industries in the wake of WWII, American steelmakers – like the U.S. auto industry - lost their dominant position. By the late 1950s, the share of U.S. manufactures in the global production of steel fell to 29%, and by the late 1960s it was around 20% (U.S. Department of Commerce 1985b: 26). In absolute terms, U.S. production of raw steel peaked at 152 million tons in 1973, but dropped drastically in the following years, as imported steel increasingly penetrated the domestic market.

Despite these similarities with the auto industry, the problems facing the U.S. steel industry in

the early 1980s were related to different underlying conditions that were more long-term and persistent. In the auto industry, declining profits were related to a change of preferences among consumers, who opted for smaller, more fuel efficient cars. In the steel industry, in contrast, the decline in demand was driven by more permanent causes, as various sectors, including construction, packaging and containers, and home equipment, turned to alternate materials such as aluminum, plastic and concrete, and auto manufacturers shifted to lighter cars that required less steel (Rogers 2009). An acute problem of over-capacity developed in the industry, with the rate of utilization dropping from around 100% in 1973 to a low point of 38% in 1982.

The steel industry responded to this problem with major restructuring at the plant level, reorganizing production to eliminate capacity and selectively modernizing existing plants (D'Costa 1999). However, the decline in profitability reduced the internal resources available for this purpose. To compensate for the deficit in internally generated funds, steelmakers borrowed heavily even before the recessions of the early 1980s: total long-term debt in the industry increased by more than 40% between 1976 and 1980 to around \$9.8 billion.

As the recessions hit the U.S. and the industry faced massive losses, CRAs started lowering the rating of large steelmakers based on their outstanding debt (Table 4.1). In January 1982, the outstanding debt of U.S. Steel, Bethlehem, Inland, National, Republic, and Armco all received an A rating from Moody's. By the beginning of 1983, Moody's downgraded the rating for Bethlehem, Inland, National and Republic to Baa, defined as "medium-grade obligation".

While the debt assumed by Wheeling-Pittsburgh was used to modernize its plants, other large steelmakers increased their borrowing for other reasons. U.S. Steel, for example, reacted to the decline in demand by diversifying its businesses. In 1982 it borrowed \$3 billion in short-term debt to acquire Marathon Oil, a debt it planned to repay by the end of 1983 (Chavez 1982;

McKay 1982). When the deal was announced, some Wall Street analysts pointed out that it could leave U.S. Steel with a cash-flow problem (Associated Press 1982a). In early 1983 the *Financial Times* reported that U.S. Steel was still struggling with the debt it assumed for the purchase (Tylor 1983). National, the fourth largest U.S. steelmaker, acquired two failing thrift banks in 1981 for \$75 million. A year later, S&P lowered the rating for National's debt and paper issues, noting that "continuing negative cash flow from operations and increasing debt usage" have reduced National's financial stability (Wall Street Journal 1982b).

Firm	Feb-80	Jan-81	Jan-82	Jan-83	Jan-84	Jan-85	Jan-86
U.S. Steel	Aa	A	A	A3	Baa2	Baa2	Baa2
Armco	A	A	A	A2	Baa2	Baa3	Ba2
Bethlehem	A	A	A	Baa2	Baa2	Ba1	Ba1
Inland	Aa	A	A	Baa2	Baa2	Baa2	Baa2
National	Aa	A	A	Baa3	Ba1	Ba1	B3
Republic	A	A	A	Baa3	Ba1	Ba1	B3
John & Laughlin	Ba	Ba	Ba	Ba1	Ba1	Ba1	B3

Table 4.1 Moody's bond rating for selected U.S. steelmakers.

In Moody's rating system, Aaa is a better rating than A and Baa is better than B. In 1983, Moody's added numerical modifiers to each alphabetic rating, with 1 being is preferable to 3.

Source: U.S. International Trade Commission (1986)

The growing reliance on debt-financing reflected the declining cashflow in the steel industry, as internally generated funds were far from sufficient to make the necessary capital expenditures (U.S. Department of Commerce 1985b). As U.S. Steel chairman David M. Roderick explained in testimony before congress, "to compensate for the deficit of internally generated funds, steel companies increased borrowings. This has resulted in increased debt ratios" (U.S. Congress 1984b: 75). However, the decline in cashflow did not prevent steelmakers from continuing to distribute dividends to their shareholders. Between 1971 and 1983, the steel industry distributed on average 10.8% of its internal funds as cash dividends to its shareholders (U.S. Department of Commerce 1985b). Between 1980 and 1982, the industry as a whole distributed dividends of

more than \$1.8 billion, including \$582.4 million in 1982, in which steelmakers reported an aggregated loss (before tax) of \$2.31 billion (U.S. Congress 1985: 180). In other words, it is not simply that steelmakers turned to debt instead of equity as a source of external finance; they actually used this debt to continue distributing dividends despite their massive losses.

As the industry continued to accumulate debts and its available resources continued to dwindle, steelmakers increasingly took on new loans to pay back the old debts. A report by the Department of Commerce succinctly summarized this dynamic: “originally driven to use debt financing as the source of funds for capital improvements and expansion, the steel industry eventually found itself in a situation where it had to rely on new debt funds to repay the interest and premiums associated with old debt rather than to improve the capital stock — a sort of ‘catch 22’” (U.S Department of Commerce 1985b: 49).

The debt burden of steelmakers made them especially vulnerable to changes in the interest rate. Thus, when the Volcker Shock pushed these rates to unprecedented heights, the interest expenses of the industry increased dramatically. Between 1981 and 1982 alone, interest payments of the U.S. steel industry almost doubled from \$877 to \$1.65 billion (figure 4.6).

Breakdown of pattern bargaining

In November 1982, a month before the concessions in Wheeling-Pittsburgh mentioned above, the USW rejected for the second time a request for early negotiations from the *Coordinating Committee Steel Companies*, which represented the large steelmakers covered by the basic steel agreement. Although senior officials in the USW supported the request, a large majority of the rank and file leadership voted against it (Shawe 1983). In the financial press, commentators complained that without such concessions from workers, steelmakers would have to continue borrowing heavily, thus “increasing their debt as revenues shrink” (Businessweek 1982).

Three months later USW agreed to wage and benefit cuts in the new Basic Steel Agreement with the remaining large steelmakers. These concessions, which were not as extensive as steelmakers originally demanded, included a \$1.31 an-hour wage cut (of which \$1.25 was supposed to be restored in stages during the term of the contract), elimination of the next five quarterly COLA clauses, and reductions in vacation time and compensation for work on Sundays. Other major concession included the termination of the Savings and Vacation Plan established in 1962 and the elimination of the Experimental Negotiating Agreement established in 1973 (Ruben 1984). The *New York Times* reported that analysts covering the steel industry estimate that these concessions would save large steelmakers about \$2 billion per year (Serrin 1983).

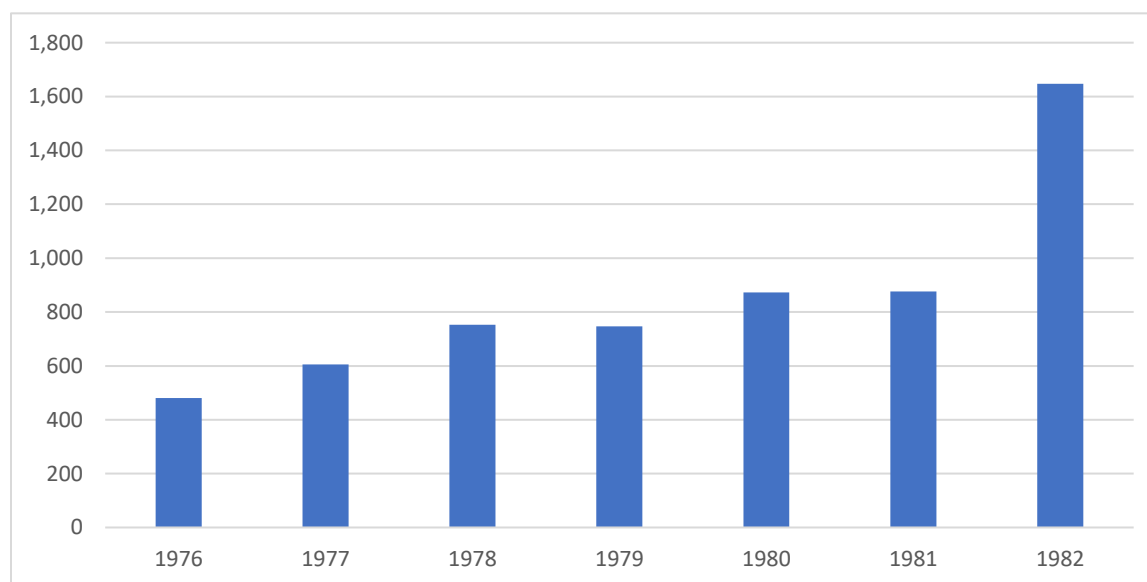


Figure 4.6 Interest expenses in the steel industry, million \$ (current prices)

Source: U.S. Congress (1985: 180)

This was the last time USW negotiated a master agreement with the large steelmakers. In 1984, National Steel withdrew from the Coordinating Committee Steel Companies, and in 1985 the remaining steelmakers announced they would no longer bargain together, thus eliminating pattern bargaining in the industry (Ruben 1986; Rogers 2009).

The concessions in the 1983 agreement did not prevent U.S. steelmakers from shutting down

plants at a fast pace in the following years (D'Costa 1999). Nor did it stop them from demanding further concessions during the period of the contract, which was to expire in mid-1986.

Already in August 1983, only five months after the new contract was signed, workers at Bethlehem's steel factory in Johnstown agreed to additional concessions after the steelmaker threatened to close its plant (Associated Press 1983a). In December 1983, U.S. Steel threatened to close factories and eliminate thousands of jobs unless workers agree to further concessions (Bohn 1983). The union refused, and before the end of the year U.S. Steel announced the largest cutbacks in its history, which included closing six major plants and the layoffs of 15,400 workers (Auerbach 1983b). USW officials described the decision as "a betrayal of contract concessions it gave the industry last March in an effort to preserve jobs and hold down production costs" (U.S. News & World Report 1984). In Wall Street, in contrast, analysts welcomed the move, and the company's stock price rose on the New York Stock Exchange after the announcement.

Wheeling-Pittsburgh, where USW made its first concessions, continued to struggle in the following years. By the end of 1984, its long-term debt was higher than \$500 million, and the firm once more turned to its workers for concessions. Labor costs, which were partially restored to \$21.4 per-hour, were expected to return to its a level of \$25 in the following year. Wheeling's management demanded to postpone the scheduled restoration. After confirming the steelmaker's financial distress, USW agreed to defer restorations indefinitely, maintaining labor costs at \$21.4 per-hour (*Re Wheeling-Pittsburgh Steel Corp* 1985). On January 1985, Wheeling-Pittsburgh asked the Union for yet more concessions, including reduction of labor-costs back to \$19 per-hour for a period of three years. As a counter-offer, USW suggested a two-year contract with labor costs of \$19.5 for the first year and \$20 for the second year, in return for common stocks in the firm and the right to appoint a member to the board of directors. However, this time the union

also demanded that the creditors of Wheeling-Pittsburgh - which included 11 banks, 12 insurance companies and the Japanese corporation Mitsubishi - make concessions of their own by forgiving part of Wheeling's debt. The union also insisted that the steelmaker not pledge any of its current assets to secure its existing debts to the banks.

Wheeling's creditors were not inclined to accept these terms. The insurance companies and Mitsubishi had strong securities against the debt and saw no reason to negotiate with the firm (Cuff 1985b). The 11 banks refused to forgive any part of the debt, and offered instead to defer payments on \$210 million of the long-term debt and provide the struggling steelmaker with an additional line of credit for \$40 million. In return, they demanded that Wheeling-Pittsburgh would pledge current assets of \$300 million to secure the entire debt.

USW refused to provide Wheeling-Pittsburgh any further concessions without a reduction of the firm's total debt outstanding. The union also opposed the pledging of current assets, which it regarded as "the only margin of safety the company had to stave off liquidation" (Cuff 1985b). The union even launched a public campaign to apply pressure on the banks: it published a full-page newspaper ad criticizing the Manufacturers Hanover Trust Company, which represented the banks in the negotiations. The ad argued that the Trust was willing to restructure the debt taken by countries in Latin America, "but it won't provide loan forgiveness and cash deferrals in exchange for stock as the steelworkers are willing to do" (Cuff 1985a).

The top management at Wheeling-Pittsburgh was livid. This was the first time a labor contract was rejected on such grounds, and management argued that its financial arrangements with the creditors were none of the union's business (Metzgar 1987). The CEO Dennis J. Carney threatened that unless USW would concede to the condition dictated by the banks, Wheeling-Pittsburgh would declare bankruptcy. The union refused, and in April 1985 Wheeling-Pittsburgh

filed for bankruptcy under Chapter 11, in what was the largest bankruptcy in the history of the U.S. steel industry to date.

Wheeling-Pittsburgh blamed the union for the bankruptcy. A press release issued by the steelmaker stated that “it is inconceivable to management that the United Steelworkers of America... forced the Chapter 11 filing by withdrawing their concession offer because they did not agree with the terms of the bank agreement” (Cuff 1985b). Joseph Scalise, vice president of industrial relations, argued that this was “probably the first time in history that a union has forced a company into bankruptcy because they didn’t like what the company was doing in their financial arrangements” (quoted in Worley 2007: 85). USW replied that workers have already provided Wheeling-Pittsburgh with \$100 million in wage and benefit concessions and were willing to give an additional \$160 million, but insisted that “it was time for the banks to do something more and make some concessions” (Cuff 1985a).

Paul Rusen, who served as USW’s chief negotiator with Wheeling-Pittsburgh, said that he was more upset with the banks than with the firm. Rusen argued that the current debt structure was totally unpayable, and explained that USW was seeking “a long-term restructuring of the debt that would make a viable company” (Gilpin & Purdum 1985)). In a later interview, Rusen said that the union decided early in the negotiations that the banks must also share some of the burden with workers. “Avoiding bankruptcy is a normal thing that unions like to do”, Rusen explained. “But it became our judgment at Wheeling-Pittsburgh that if there wasn’t a restructuring of the debt... they would end up in a liquidation situation anyhow” (Metzgar 1987: 67).

A month after declaring bankruptcy, Wheeling-Pittsburgh proposed to its workers a five-year contract which cut labor cost to \$15.20 per-hour, reduced medical and insurance benefits, and eliminated COLA provisions and various other prior obligations, including payments to the

pension plan. The firm threatened to seek court authorization to reject the existing collective agreement unless the union agreed. The Union, hoping to avoid such a ruling, agreed to reduce labor costs to \$18. Management refused, and on May 31, 1985, the firm asked the bankruptcy court for authorization to reject the existing agreement (*Re Wheeling-Pittsburgh Steel Corp* 1985). On July 1985, the bankruptcy court authorized the rejection of the collective agreement with USW, and a few days later 8,200 militant workers at Wheeling-Pittsburgh went on a “make-or-break” strike (Hall & Taylor 1985). The CEO Carney warned that a strike would force the company into liquidation. USW negotiator Rusen replied that the firm was getting what it deserved for “attempting to rob its workers to pay the banks” (quoted in Worley 2007: 82).

The strike marked the first major work stoppage in the steel industry since the 116-day walkout of 1959. It lasted 98 days, and led to the ousting of CEO Dennis Carney, who was replaced by George A. Ferris, a more union-friendly executive, who agreed to open the books so the union could assess the financial situation of the firm. This move opened the path to a new collective agreement signed in October 1985, which reduced labor costs to \$18 per-hour. At the demand of Wheeling’s creditors, the firm eliminated its underfunded pension plans. Workers also agreed to the elimination of COLA, and further restrictions on vacation time, holiday pay, and health insurance benefits. Against these concessions, Wheeling-Pittsburgh agreed to appoint two union representatives to the board of directors and provide the union with complete access to its financial records (Worley 2007). Reviewing the outcomes of the strike, *BusinessWeek* noted that the union effectively “called the bankers’ bluff, armed with the knowledge that the company was worth more to its creditors alive than dead” (Kuttner 1986: 22).

The Airline Industry

“The all too familiar scenario goes like this. The leadership of a pilot group is called into the

CEO's suite for a 'frank discussion'... Once there, it is presented with detailed information of how the carrier simply cannot make it without help from its employees... (If) the pilot group is unreceptive to the CEO's pleas for help, he starts playing 'hardball' by threatening to furlough a substantial number of pilots and resize the airline. If this doesn't work, a complete shutdown through Chapter 11 bankruptcy proceedings is threatened... This tactic is usually arranged to coincide with *a timely visit from one of the airline's friendly bankers*. Faced with these options, our pilots have generally agreed to management's demands. When one employee group has given in, management goes after the others" (U.S. Congress 1983b: 165. My italics).

This vivid description was given in June 1983 by Henry Duffy, president of the Air Line Pilot Association (ALPA), during a congressional hearing on the deregulation of the airline industry. Top airline executives who spoke before Duffy denied the negative impact of deregulation on their businesses, blaming labor costs and excessive wages for the industry's troubles. Duffy pointed out that "while airline management may have concealed the extent of their problems caused by deregulation in their testimony, let me assure you that they have made no effort to disguise their plight in discussions with labor" (U.S. Congress 1983b: 162).

Deregulation and corporate debt

The airline industry is very different from the auto or steel industries. Most obviously, airlines are not part of the manufacturing sector. Unlike cars or raw steel, their product is highly perishable, since unfilled seat cannot be stored for future sale. Airlines are also more sensitive to business cycles, especially with respect to pleasure travel. At the same time, airlines have high fixed costs due to the price of aircrafts and the large labor force required to maintain them. This is why airlines tend to be more financially leveraged than firms in other industries.

Throughout the postwar era, D/E ratio for American airlines was three-to-four times higher than

the average D/E ratio for other industries. Nevertheless, airlines were considered a stable investment thanks to the strict government regulation of the industry. During the postwar era, the Civil Aeronautics Board (CAB) regulated all domestic interstate air routes, setting fares as well as schedules. CAB allowed carriers to predict with some confidence their overall costs, and gave creditors confidence that the interest on debt would be paid on time. If an airline found itself in financial difficulties, CAB would facilitated a merger with a stronger airline (Wensveen 2007).

Since the early 1950s increasing demand for local air transportation led CAB to award routes to newly founded airlines that provided service between smaller cities and central destinations. The industry expanded rapidly, and from 1950 to 1970 the number of passengers grew more than tenfold (Cook 1996). However, high fares limited air travel to business passengers and affluent customers. Prohibited from competing on price, carriers reacted to rising demand with increased flight frequency, lower seating density, and extravagant in-flight service.

In the mid-1960s, excessive optimism led airlines to overinvest in large-capacity jet aircraft, and the average capital expenditure from 1965-1969 grew to \$1.6 billion per year, more than double the average annual expenditure for 1960-1964 (Air Transport Association 1970). As declining earnings in the late 1960s reduced internal funds available for spending, airlines financed most of these investments with debt, and the average D/E ratio for the industry quickly rose. In response, CAB approved an agreement between major airlines to reduce the number of flights on domestic routes and increase their fares by 20% (Allvine, Uslay, Dixit, & Sheth 2007). The agreement helped reduce debt levels in the industry by the late-1970s, but it also aided advocates of deregulation, who argued that government involvement in the industry imposed a heavy burden on the economy and society. In 1978 Congress passed the Airline Deregulation Act, which mandated CAB to phase out its route approval authority over three years, regulation of fares over

five, and pass its remaining functions to the Department of Transportation (Cook 1996).

Following the deregulation act, large carriers quickly expanded into previously restricted routes, while local airlines entered interstate routes. At the same time, new “startup” airlines emerged to take advantage of the opportunities offered by the new business environment. From 1978 to 1979 alone, the number of airlines operating in interstate and international routes grew from 23 to 34, while the total number of aircraft in service, which declined by 7% between 1970 and 1978, jumped 12% (Air Transport Association 1981; Jordan 2005). Just as in the late 1960s, airlines financed their aggressive expansion efforts mainly through debt. The D/E ratio for the industry reached a low point of 1.95 in 1977, quickly climbed back up, and in 1980 was already at 2.76 (figure 4.7). By 1982, D/E for the entire industry was 3.35. This time, however, CAB was no longer present to assist airlines with their increasing debt burden.

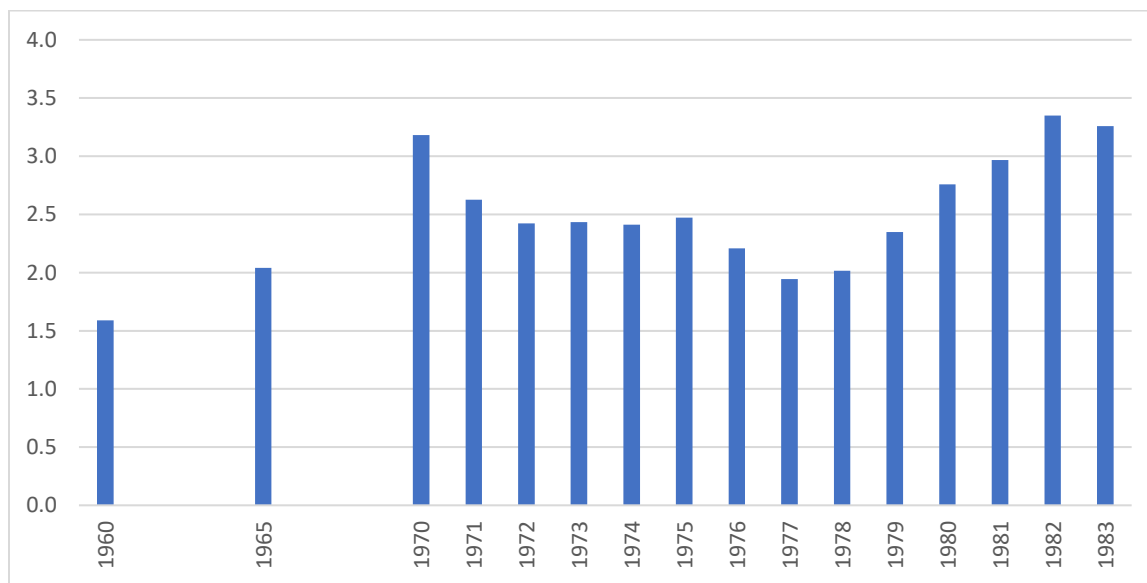


Figure 4.7 Debt-to-equity ratio for the U.S. airline industry

Source: Own calculation based on data from Civil Aeronautics Board reports, various years

For U.S. airlines, deregulation could not have come at worst time. Following the Iranian Revolution of 1979, oil prices almost doubled by the end of the year. In 1979 fuel expenses for the industry amounted to \$6.5 billion, a jump of 55% compared with 1978. The fierce

competition that developed following the deregulation act prevented airlines from compensating for the costs of fuel with higher prices. Thus, although annual revenues for the industry grew by about 17% due to a rise in the number of passengers, operating profit was cut to \$409 million, a decline of 66% from 1978 (Air Transport Association 1980). Declining profits from 1979 onwards reduced the internal funds available for investments, and raised concerns about the ability of airlines to service their high debts.

It was under these already adverse conditions that the Volcker Shock dealt another blow to the airlines by pushing up the cost of borrowing. Adjusted for inflation, annual interest expenses in the industry rose by 90.7% from 1977 to 1980, after declining by 28.9% from 1974 to 1977 (figure 4.8). In total, real annual interest expenses rose by 133% between 1977 and 1982, while operating revenue (adjusted for inflation) grew by less than 15%.

The economic recessions that followed the Volcker Shock further exacerbated the situation in the industry. In 1980 air traffic declined by 3%, the sharpest drop in the history of U.S. air transportation up to that point, while oil prices continued to rise, driving up annual fuel expenses by another 50%. For 1981, the industry reported a net operating loss of \$222 million, the highest in its history. Among the four largest airlines in terms of passengers, only Delta managed to make a net profit in 1980, while United, American, and Eastern Airlines reported an aggregated net loss of \$116 million. (Air Transport Association 1981). In an effort to bring in more cash, some airlines reduced their fares even further, sometimes below the break-even point at full capacity, which led many airlines to bankruptcy. Such instances, which were very rare during the postwar era, became a common feature following the deregulation act. In 1979, the first year of deregulation, two carriers filed for chapter 11. In 1980 the number rose to four, then six, and in 1982 no less than 12 airlines declared bankruptcy, including Braniff, which in 1981 was the tenth

largest U.S. carrier in terms of passengers and employees.

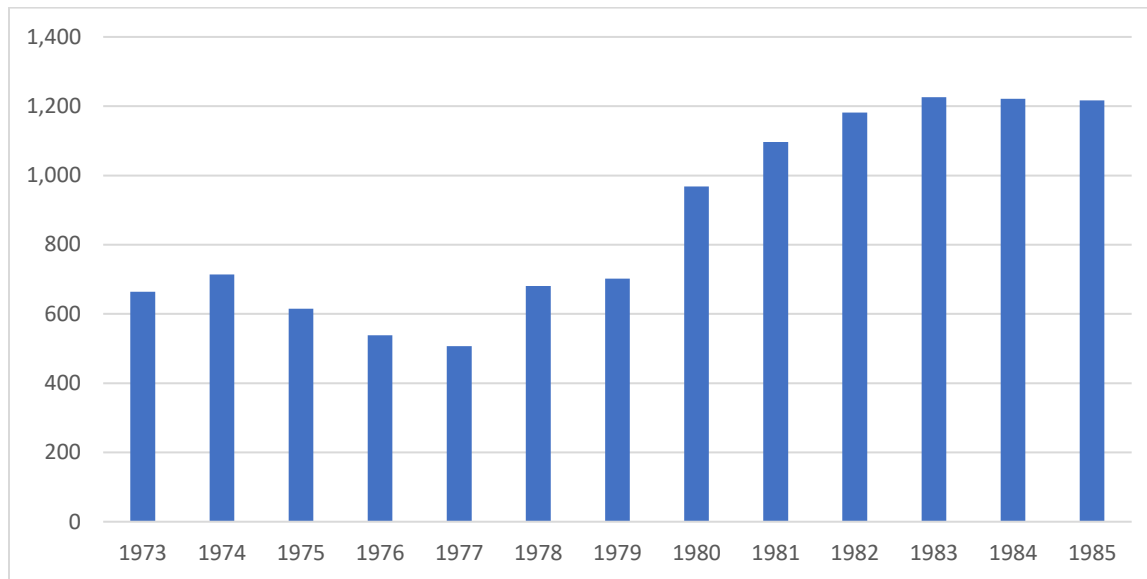


Figure 4.8 Interest expenses in the U.S. airline industry, million \$ (1980 prices)

Source: Own calculation based on data from Air Transport Association reports, various years

Planning for a massive expansion following deregulation of the industry, Braniff made an order for 41 planes from Boeing, with an option for additional 44 (Rosenthal & Selcraig 1981). This ambitious plan encountered difficulties in the following years, as the airline lost a total of \$279 million during 1979-1981. Unable to continue servicing its \$733 million debt, in mid-1981 Braniff started negotiations with its 39 creditors, which agreed to postpone interest and principal payments until October 1982 (Salpukas 1982). In January 1982, in an effort to stay afloat, Braniff slashed its fares by 45% on average, forcing competing airlines to match its low fares (Meyer et al. 1987: 77). Despite these efforts, Braniff declared bankruptcy in May 1982 becoming the first major airline to fail in U.S. commercial aviation history (Fischer 1982).

Despite these problems, in the first two years after deregulation, unions were able resist the pressure from management, and wages and benefits continued to rise across the industry (Wensveen 2007: 414). The situation changed following the failed strike of the Professional Air Traffic Controllers Association (PATCO), which ended with President Reagan firing the 11,345

striking air traffic controllers (see Ruben 1982). Some argue that breaking the PATCO strike “was clearly meant as a message to business and labor alike: that the bargaining atmosphere had changed in both the public and the private sectors” (Moody 1988: 141). Whether this was the case or not, the event certainly weakened the resistance of airline workers to concessions. Following the failed strike, workers at Braniff, Pan Am and Continental agreed to a 10% pay cut for a fixed period, and those in Eastern, Western and Republic soon followed suit (Lieb & Molloy 1987).

In contrast to the industrial unionism in the auto and steel industries, where a single union represented all of the workers in the industry, collective bargaining in U.S. airlines was always highly fragmented. Various unions represented specialized crafts such as pilots, flight attendants, mechanics, and ticket agents, and in some cases, a single airline had to deal with up to a half-dozen unions, a situation which led to lengthy contract negotiations, bargaining impasses, and bitter strikes (Chaison 2012). Nevertheless, the rise of concession bargaining in the airline industry followed a similar pattern to the auto and steel industries. It started in the more financially leveraged airlines, as evident in their high D/E ratio (figure 4.9). In contrast, pilots at United Airlines, which maintained a lower level of debt, secured a 29% raise over a 26-month contract (Ruben 1982). However, carriers facing no financial problems were quick to take advantage of the general trend. As ALPA president Duffy noted, even carriers that require no concessions “are asking for it anyway because they don't want to miss out on the opportunity while it is there” (U.S. Congress 1983b: 166). Unions reacted by demanding that airlines open their books to provide evidence that wage cuts were indeed necessary, as well as a voice in future strategic decisions (Wensveen 2007: 415).

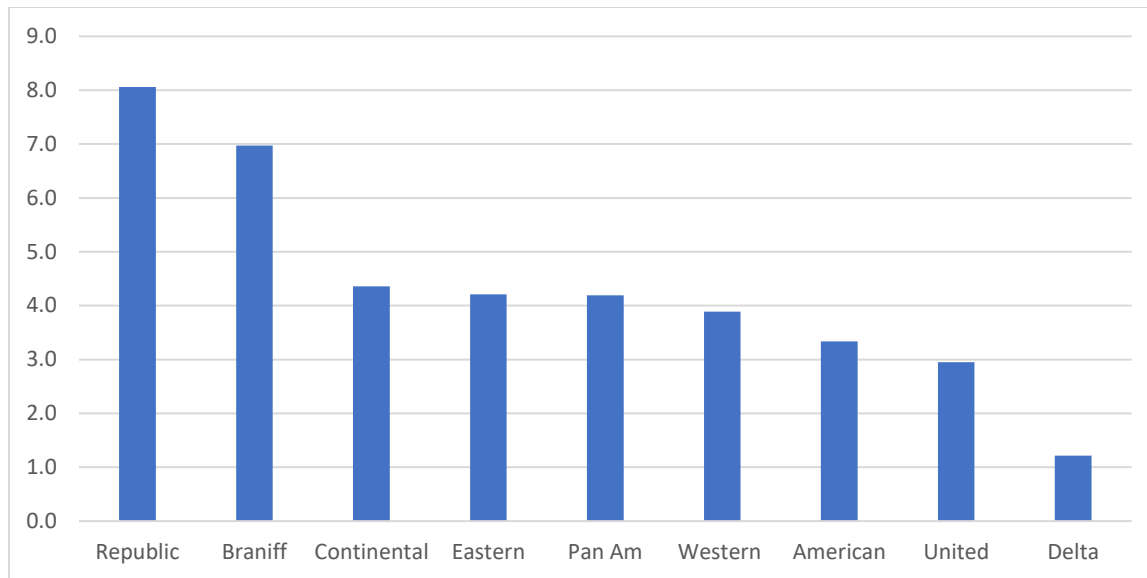


Figure 4.9 Debt-to-equity ratio for selected airlines, June 1981

Source: Own calculation based on data from Civil Aeronautics Board reports, various years

From Pilots to Financiers

The airline industry provides the clearest illustration of the strategic use of corporate debt, which became common during the 1980s wave of leveraged buyouts (LBOs) and hostile takeovers that swept through the industry. In the case of Pan Am, for example, corporate debt almost doubled during 1980 following the takeover of National Airlines, bringing its D/E ratio from 2.4 in December 1979 to 5.09 in June 1980. Pan Am sought to acquire National in an effort to expand its operations to new routes in the new deregulated environment. However, the high price it paid was also the result of a bidding war with Frank Lorenzo of Texas International Airlines (TXI), who started buying National's stock when it was at \$17 a share, and ended up selling it to Pan Am at more than \$50 per share, walking away with a profit of around \$40 million (Dempsey & Goetz 1992). It was Lorenzo more than anyone else in the airline industry who pioneered the financial methods of LBOs, and brought the strategic use of corporate debt close to perfection through his use of the protection provided by chapter 11 bankruptcy.

Until the late 1970s, airline entrepreneurs and executives came mainly from the field of aviation

itself. Aviation pioneers like Robert Six, who led Continental Airlines for more than 40 years, Jack Frye, who founded Standard Air Lines and turned Trans World Airlines (TWA) into a leading carrier, and Juan Trippe, founder of Pan American World Airways, were themselves pilots before establishing their own airline. Lorenzo, however, was part of a new generation of businesspeople who were interested in the return on their investment rather than any “mystique of aviation” (Hopkins 2000: 110). He started his career in the airline industry as a financial analyst, first for TWA and then for Eastern. In the late 1960s he and a friend from Harvard Business School started their own airline advisory company called Jet Capital Corporation. In 1971 Jet Capital was asked by Chase Manhattan Bank to act as consultants for a failing airline called Texas International Airlines (TXI) on how to avoid bankruptcy. A year later Lorenzo suggested that Jet Capital take over TXI through a complex refinancing agreement. Lorenzo ended up paying only \$1.2 million for 26% of the stocks and 59% of the voting rights in TXI, and at the age of 32, he became president and CEO of the certified airline (Bernstein 1999).

According to Dennis Higgins, union leader of TXI pilots at the time, Lorenzo “knew only one way to produce profits. That was by manipulating the employees’ pay downward and their productivity upward” (quoted in Hopkins 2000: 116). In 1974, Lorenzo decided to turn some of the baggage handlers and ticket agents into part-time employees. When the workers declared a strike in December 1974, Lorenzo responded by hiring “permanent replacements”. This led ALPA and the International Association of Machinists and Aerospace Workers (IAM) to join the striking ground workers. Lorenzo replied by filing a lawsuit for \$3 million against ALPA and obtaining a court injunction against TXI’s pilots (Hopkins 2000). The strike grounded TXI for four months, but in April 1975 ALEA capitulated and returned to work under the new conditions (Bernstein 1999). Lorenzo managed to turn TXI into a profitable business by eliminating

unprofitable routes in exchange for more lucrative destinations, and receiving federal approval to offer half-price, “peanut fares”, which earned him a reputation as a “cost-cutter”.

Before the Airline Deregulation Act of 1978, CAB’s supervision of labor relations in the industry served to hold Lorenzo’s anti-union plans in check. Once deregulation was underway, however, Lorenzo began pressuring TXI’s pilots for changes in their contract and work rules. The pilots expressed their displeasure in every possible way short of getting themselves fired. In February 1980, a three-day “sick-in” landed them in court, after Lorenzo served them with a “cease and desist” order, while sending nurses to the homes of sick pilots to check on them (Hopkins 2000).

Around the same time, Lorenzo created a new holding company called Texas Air Corporation, with TXI as its subsidiary. In the autumn of 1980, he established another subsidiary “startup” airline named New York Air, which provided low-fare flights between New York, Washington D.C., and Boston. New York Air used aircraft from TXI, which were repainted with its logo and operated with non-union crews that Lorenzo trained at TXI’s school in Houston (Hopkins 2000: 121). New York Air’s non-unionized pilots were paid about 34% of the salary of unionized pilots at Eastern Airlines, its most direct competitor, and its flight attendants and sales personnel were paid 55%-57% of the salaries of unionized ground-workers in Eastern (Fischer & Belous 1984). In the following years, such “sibling”, low-fare, non-unions carriers were set up by other airlines, for similar purposes (Hopkins 2000). When Lorenzo launched his takeover of Continental in 1981, he had already gained a reputation as “union buster” as well as “cost-cutter”.

Like Braniff, Continental expanded aggressively following the deregulation of the industry, and was under serious financial stress after losing a total of \$94 million between 1979 and 1981.

Continental was already negotiating a merger with Western Airlines when Lorenzo began buying

its stock through TXI. In February 1981, TXI publicly announced its plans to acquire Continental, after buying 9.5% of its stock. TXI continued to buy Continental's stock, and once it owned 48.5% of the total, submitted an official tender offer for the rest of the stock. To finance the takeover, TXI relied mostly on debt, including a \$50 million loan from the Manufacturers Hanover Trust. As a result, total debt for TXI grew by 50% within three months, from \$169 million in December 1980 to \$254 million in March 1981.

Lorenzo's plan included three steps. First, taking over Continental using money borrowed by TXI. Second, transferring Continental's stocks from TXI to Texas Air, while leaving the debt on TXI's balance sheet. Third, merging TXI with Continental, so the debt from the takeover ended up on the balance sheet of the target airline itself.

Although Lorenzo did not disclose the details of the plan, his intentions were clear to Continental's employees and management alike. Robert Six, Continental's CEO from 1936 to 1980 who served as chairman of its board, replied to Lorenzo that his proposal "would create a company so overburdened with debt that it would, in my judgment, be unfair to the employees. The bottom line is you are asking our employees to help pay for your purchase of Continental. That is clearly unfair" (quoted in Hopkins 2000: 153). Continental's CEO Alvin Feldman wrote to Lorenzo that a merger between TXI and Continental would create a financially weak airline that is not likely to survive. Feldman noted that the operating profit required to service the enormous debt of the combined airline "is more than our two companies together have ever earned" (quoted in Dempsey & Goetz 1992: 68-69).

From the side of labor, TXI pilots took the unusual step of attending Continental's shareholder meeting to deliver a warning. "We have come to this meeting at personal risk to tell you some hard truths about dealing with Frank Lorenzo", TXI pilot Dennis Higgins told the audience. "Mr.

Lorenzo is a brilliant man, perhaps a market manipulator without peer. We are here, however, to tell you that he is also a man who has done nothing to show that he cares one whit for the 3,400 Texas International employees who work for him” (quoted in Petzinger 1996: 219).

Continental’s workers tried to block the takeover by acquiring a controlling interest in the airline through an Employee Stock Ownership Plan (ESOP). The plan received the support of Continental’s top management, but the airline’s lead creditor, Chase Manhattan Bank, was strongly opposed, apparently preferring Lorenzo’s cost-cutting strategy (Delaney 1992: 92). The plan was ultimately thwarted by the California Corporations Commissioner, where Continental was incorporated, who ruled that it could not issue millions of new shares to employees without the approval of all existing shareholders, including TXI itself (Petzinger 1996: 220). Lorenzo won the battle over Continental and took control of the airline.

Lorenzo wasted no time. In December 1981 he attended his first board meeting, and in January 1982 Continental laid-off more than 1,500 of its non-union employees, almost 15% of its total workforce (Facts on File World News Digest 1982). He imposed a 15% wage reduction on remaining non-union employees, which saved the airline \$30 million (Delaney 1992: 94). At the same time, he warned the airline’s major unions – ALPA (pilots), IAM (mechanics, kitchen workers, and cabin cleaners) and UFA (the Union of Flight Attendants) - that without concessions they could expect more massive layoffs (Shifrin 1982). In August 1982, Continental’s pilots agreed to wage concessions worth \$90 million, as well as extending their flight hours to improve productivity (Petzinger 1996).

The concessions made by the pilots cleared the way for the planned merger between Continental and TXI, which established a new corporate entity named Continental Airlines Corporation (Associated Press 1982b). In exchange for each stock of Continental, existing shareholders

received a 0.4 common stock and 0.2 preferred stock in the new corporation (Fox 1982).

As expected, the merged airline was highly leveraged from the very start. Current liabilities jumped by 95%, from \$201 million in September (pre-merger) to \$392 million in December (post-merger), while long term debt rose by 82% from \$241 million to \$439 million. At the same time, the total assets of the merged airline increased by only 27% compared to pre-merger Continental. Shareholder equity in the merged airline was cut by more than half, from \$108 million in September to \$50 million in December 1982 (Civil Aeronautics Board 1983).

In the first half of 1983, Continental reported a net loss of \$84 million, and Lorenzo turned to the pilots once more for concessions. They asked him to “open the books” to show the actual financial situation of the airline, and demanded joint meetings with creditors. Lorenzo refused. With IAM, probably the most militant of the airline’s unions, Continental adopted a strategy of reducing its offer as negotiations continued, leading IAM to suspect Lorenzo was trying to ensure a strike. In fact, a whole two months before the mechanics walked out, Lorenzo told Continental’s pilots that he expected IAM to strike, and demanded that the pilots continue flying nevertheless (Hopkins 2000: 134). During the summer of 1983 Continental trained new mechanics to replace its unionized employees, as well as 800 flight attendants, in case the UFA decide to join the IAM (Associated Press 1983b).

In mid-August 1983, IAM declared a strike at Continental. That very same day, the airline eliminated 680 jobs by outsourcing its food services to Marriott, and another 120 other jobs through various “efficiency” measures (United Press International 1983). Management’s threats on the pilots and flight attendants proved effective, as they crossed the picket line and continued flying. Continental reported that it was “business as usual” on 85% of its routes (Associated Press 1983b). Two days into the strike, Continental announced it would begin “permanently

replacing" mechanics who failed to report for work (New York Times 1983). These replacement were paid about 67% the pay of unionized mechanics (Delaney 1992: 95). A split in union ranks between Continental and TXI employees also weakened the strike, as a substantial number of mechanics crossed the picket line and returned to work. IAM filed suit in federal court seeking to nullify Continental's contracts with the replacement mechanics, but this did little to help (Associated Press 1983c). By the end of August, Continental was making more than 90% of its scheduled flights.

Encouraged by the success, Lorenzo turned to Continental's pilots and flight attendant for more wage concessions. In September, he demanded the pilots accept a wage cut of almost 50%, although their existing contract was in effect until the end of 1984 (Petzinger 1996). Lorenzo threatened that if the demand were rejected, the airline would take the necessary actions "to protect our liquidity and other sources" (quoted in Delaney 1992: 95). The president of Continental, who preferred a settlement with the pilots and disapproved of Lorenzo's tactics, was pulled from the negotiations and resigned shortly after (Hopkins 2000). Three days later, in September 24, Continental filed for chapter 11 bankruptcy.

Despite its enormous debts, Continental was still solvent at the time of the filing. It was able to file for bankruptcy despite its solvency thanks to the changes in bankruptcy laws enacted in 1978. In its filing Continental stated that it expected to run out of cash by the end of the month. However, according to its financial report to CAB, it still had \$54 million in cash and marketable securities, \$240 million in notes and accounts receivables, and \$93 in current investments and special funds (Civil Aeronautics Board 1983). In fact, Continental's cash position had actually improved since the beginning of 1983. In an interview for the *New York Times*, Lorenzo stated that Continental had no cash problem, only a labor problem (Delaney 1992: 96).

No less important, Texas Air Corporation, Continental's parent company, had about \$288 million in cash and current assets, with almost no debt on its balance sheet (Hopkins 2000). As the largest shareholder in Continental, Texas Air could have easily kept the airline afloat. However, Lorenzo had no intention of doing so, stating: "we're not running a welfare agency" (quoted in Petzinger 1996: 238). The pyramidal structure of the holding company also made it hard to track the flow of assets and cash between the different corporate levels. During the negotiations with ALPA, the pilots demanded that Lorenzo "open the books" not only for Continental but also for Texas Air. In his testimony before congress, ALPA's President Henry Duffy stated that a "great shell game exists in these holding companies, and it's very difficult for us to see what the resources really are because of the ability to flow assets back and forth" (U.S. Congress 1984a: 24).

Hours after filing for bankruptcy, Continental nullified its existing collective agreements and laid off almost all of its 12,000 employees. It then rehired a third of them under new work rules and for about half the pay (King 1983). Despite the outcry from the unions, three days after filing for bankruptcy the airline resumed its flights on a reduced schedule, offering ultra-low fares of \$49 to all its destinations. Continental's unions, including ALPA, IAM, and UFA, filed a motion to dismiss the rejection of their collective agreements. They argued that the main purpose of the bankruptcy was to break the unions at the airline, and that the turn to chapter 11 was "engineered over a long period of time by management" (New York Times 1984). Duffy called the move "a blatant misuse of the bankruptcy laws... a cold calculated maneuver to do away with labor contracts" (World News Tonight 1983). The unions submitted to the court as evidence a note written by a top official three months before the bankruptcy, which stated that management needed an "awfully big stick" in its negotiations with the pilots and that the "most effective stick

might be chapter 11” (quoted in Delaney 1992: 94). Nevertheless, a federal bankruptcy judge denied the unions’ motion. In his ruling the judge stated that the primary purpose in filing for bankruptcy was to keep the airline operating, and that “the management of the company owed this obligation to its shareholders and to its creditors” (Business Wire 1984).

Whether or not Continental was actually on the verge of insolvency, it is at least clear that its financial predicament was not simply the outcome of changes in its business environment, but resulted from Lorenzo’s financial engineering and shifting assets between corporate entities. The outcome of these maneuvers was hardly a surprise: this was exactly what Continental’s previous management worried about. Unions opposed the deal on the very same grounds.

Continental’s move brought the issue of strategic bankruptcy to public attention, and contributed to subsequent revisions of bankruptcy laws (e.g. Delaney 1992; Moulton & Thomas 1993; Ceccotti 2007). Two weeks after the filing, Congress held a hearing on the impact of chapter 11 protection on the stability of labor-management relations, from which the opening quote in this section is taken. Lorenzo and other Continental executives were asked to testify, but decided to pass on the invitation. Henry Duffy from ALPA argued that the entire structure of labor-management relations in the U.S. was being jeopardized by the actions of Continental (U.S. Congress 1984a: 4).

Although Continental provides one of the clearest examples of strategic bankruptcy, it was not the first to use chapter 11 in an attempt to eliminate its collective agreements, even within the airline industry. Braniff, which filed for bankruptcy in mid-1982, did exactly the same. Wilson Foods, a large retail chain store, filed for bankruptcy a few months before Continental. The retailer stated in its filing that labor costs had placed it at a competitive disadvantage and asked the courts to reduce them immediately (Barmash 1983). When Continental filed for bankruptcy,

the Supreme Court was already scheduled to hear arguments in the case of the National Labor Relations Board (NLRB) v. Bildisco & Bildisco. This case involved a decision by NLRB that the rejections of collective agreements under chapter 11 constitute an “unfair labor practice”. In February 1984, the Supreme Court ruled against NLRB. In its decision, the court stated that a bankrupt company does not commit an unfair labor practice when it unilaterally rejects a collective agreement even before it receives permission from the Bankruptcy Court (*NLRB v. Bildisco & Bildisco* 1984).

Unions lobbied congress to revise the act, declaring it to be their “top lobbying priority” for 1984 (Keller 1984). Congress indeed revised the bankruptcy laws in 1984 by adding restrictions on the rejection of labor agreements (section 1113), and then in 1986, following the bankruptcy of Ling-Temco-Vought (LTV) Corporation, adding provisions for the elimination of retirees’ health, life insurance and disability benefits. However, these changes did little to eliminate labor-targeted bankruptcies, which became more frequent by the late 1980s. As the *New York Times* noted, “bankruptcy courts have become forums for airing product-liability problems and labor disputes” (Labaton 1990). More recently, a lawyer representing labor unions in bankruptcy cases in the airline, steel, auto other industries noted that the resurgence in strategic bankruptcies before the financial crisis of 2008 is reminiscent of the early 1980s, “when companies saw bankruptcy as a potent instrument in labor-management relations (Ceccotti 2007: 415).

Delaney (1992) suggests that the strategic use of bankruptcy by large corporations was the outcome of profound changes in the economic, political, and legal landscape of the U.S. economy, which “led to broader, more contentious definitions of seemingly technical, quantifiable concepts such as debt, liability, and bankrupt” (p. 7). These profound changes are part of the shift in property relations that underlie the rise of finance, which turned corporate debt

into another weapon in the arsenal of corporate executives.

Strategic bankruptcy is only a logical continuation of the strategic use of corporate debt, which is the focus of the present research. But once this use of bankruptcy law becomes a common practice, it has a feedback effect that strengthens the impact of debt on wage negotiations. Thus, less than a week after Continental filed for bankruptcy, the chairman of Eastern Airlines, Frank Borman, threatened that he might take similar steps unless workers agreed to a 15% pay cut (Facts on File World News Digest 1983). Eastern did end up filing for bankruptcy, but only in the late 1980s, after Lorenzo took over the airline using similar financial tricks to those he used at Continental. Carl Ichan, who beat Lorenzo in a bidding war over TWA in 1985, took the airline on a similar path in the early 1990s. In the steel industry it was Wheeling-Pittsburgh in 1985 and LTV corporation in 1986, and there are many other examples. These represent only the tip of iceberg, as the turn to strategic bankruptcy indicated that the strategic use of corporate debt was not enough to extract wage concessions from workers. Thus, for each firm that ended up in a strategic bankruptcy there were likely many more firms in which workers agreed to wage and benefits cuts, making the use of chapter 11 superfluous.

Conclusions

This chapter traced the use of corporate debt as a negotiation tool in U.S. collective bargaining processes during the economic recessions of the early 1980s. While the existing literature suggests that the growth of corporate debt was driven by the adoption of the SV approach, this trend actually started soon after WWII, from which American NFCs emerged almost free of debt. Throughout the prosperous years of the postwar era, NFCs increasingly relied on debt to finance their operations and expand into new markets. This was not unusual, given that corporate borrowing tends to be procyclical, which means that corporate debt rises as the economy grows

and declines when it contracts (Adrian & Shin 2014). However, instead of paying back their loans during the economic downturn, corporate debt only accelerated during the economic turmoil that plagued the U.S. economy in the 1970s. “The more stagnation spread, the greater the reliance on debt as a prop to the economy” (Sweezy & Magdoff 1987: 15). High inflation contributed to this trend by eroding the real value of debt and effectively transferring income from creditors to debtors. The Volcker Shock put an end to this implicit redistribution.

In the previous chapter I argued that the transformation of corporate debt into a negotiation tool depended on the broader shift in property relations that accompanied the rise of financial assets as a dominant form of property. I emphasized the importance of incorporating CRAs into the financial regulatory framework and the reform in bankruptcy laws. As we have seen in this chapter, CRAs increased the financial pressures on troubled NFCs by downgrading the rating on their debt, while the Bankruptcy Reform Act of 1978 provided the “hard place” for the “rock” of corporate debt, as it made clear that rejecting the demand for concessions might leave workers without a job at all. While the practice of strategic bankruptcy played an especially central role in the airline industry, the mere threat of bankruptcy undermined the bargaining position of labor. As one report from the Congressional Research Services stated, “even if it remains only a threat in most cases, the potential for declaring bankruptcy could have a significant effect on labor-management relations... in weak economic periods the threat of bankruptcy could improve management's bargaining position even if no Chapter XI case is actually filed” (Belous 1985: 6).

While the recessions of the early 1980s were strongly felt across the economy, each of the three industries reviewed above also faced its own set of problems and difficulties. In the auto industry, high oil prices led to a shift in consumers preferences, as many Americans turned to the smaller, more fuel-efficient cars produced by foreign manufacturers. New government

regulations required increased capital expenditure in a period of declining sales and reduced the available funds of U.S. auto manufacturers, forcing them to take on more and more debt to make the necessary investments, at a time when raising interest rates pushed up the cost of borrowing. By using their debt burden to extract wage concessions from workers, large auto manufacturers ensured that the future gains from these investments would benefit shareholders rather than workers, as was the case during the economic downturn of the late 1960s.

The decline of the U.S. steel industry was related to a more permanent drop in demand, as various other industries turned to use alternative materials and the aggregated demand for steel declined. Here the main problem was over-capacity, and debt was used to reorganize production, selectively upgrade existing facilities, and diversify their operations through acquisition of existing firms in different industries. However, given the persistence of the problems in the industry, new debt issued at higher interest rates was increasingly used to repay old debt rather than make the required investments. Wage and benefit concessions extracted from workers provided a solution to this “vicious cycle” of debt begetting even more debt, as savings from labor costs were used to service the enormous debts accumulated by large steelmakers.

In both the auto and the steel industries, American manufacturers faced increased competitive pressure from foreign manufacturers, which had an advantage in the form of lower labor costs. Thus, it can be argued that the problems in these industries had more to do with the logic of *globalization* than class struggle. However, this cost advantage should be also understood in class terms. In both Japan and Germany, domestic manufacturers benefited from a large industrial reserve army, previously employed in agriculture and small businesses, which opened the path for rapid increase in productivity (Brenner 2006).¹⁰ As we have seen, throughout the

¹⁰ While outside the scope of the present investigation, from a global perspective the cost advantage of German and

period many firms continued to distribute dividends while demanding concession from their workers. Clearly, managers could have used these funds to reduce their corporate debt rather than distribute them to their shareholders. That the distribution of dividends continued even in the face of mounting losses also helps expose what some legal scholars call “the myth of shareholder ownership” (e.g. Ireland 1999; Stout 2012). What shareholders actually own, as their title implies, is the share issued by the corporation, a share which is financial asset, i.e. a contractual obligation which provide its holder with the right to receive income from the corporation under certain conditions. In this sense, as noted before, shareholders are not much different than corporate creditors (banks and bondholders alike). Unlike the small business owner, they are not liable for the debts of the corporation, and can continue to receive dividends while the corporation they “own” reports huge losses year after year.

In the case of the airline industry, foreign competition played no role the crisis of the early 1980s. The problems facing air carriers had nothing to do with the logic of globalization, but rather with *neoliberalism* and its penchant for deregulation. The competition in the industry was the outcome of the Airline Deregulation Act of 1978, which eliminated the existing restrictions on air routes, fares, and schedules. The fierce competition was translated to heavy losses, which led airline executives to take a much firmer stance in their negotiations with unions. Here the strategic use of debt was related to the wave of mergers and acquisitions, the rise of hostile takeovers and the spread of LBOs. Loading up target airlines with the very same debt used to acquire them, and then cutting wages to pay back these loans, represented the strategic use of

Japanese industries should also be viewed as part of the historical development of the class struggle in these countries. Ironically, the U.S. itself helped ensure that the productivity gains in Germany and Japan would not push up wages. After the end of the war, its occupation authorities joined conservative governments and employers to contain or repress the wave of strikes in Germany and Japan, thus helping weaken trade unions in these countries (see Brenner 2006; Gindin & Panitch 2012; Ono 2018).

debt in its most pristine form, a form that was quickly taken up by private equity funds and investment firms such as Kohlberg Kravis Roberts (KKR), Bain Capital, and others.

Despite the differences between them, in all three industries the use of corporate debt as a strategic tool developed in a similar way. It started in financially distressed firms that were actually facing a potential bankruptcy, which they sought to fend off by reducing labor costs and other measures. However, it quickly spread to stable firms in the industry that were facing no immediate dangers. At this meso-level analysis, organizational theory provides a useful guide to examine the diffusion of this practice. Indeed, the use of debt as a negotiation tool spread across organizational fields (industries) like “fads spread through high schools” (Dobbin & Jung 2010: 33). Its diffusion involved coercive, mimetic, and normative mechanisms (DiMaggio & Powell 1983). Coercive, as firms faced pressures from creditors as well as the policies of the Federal Reserve; mimetic, since this practice was quickly adopted by other firms in the industry once it proved useful; and normative, as it involved the social construction of downsizing (Budros 1997) and bankruptcy (Delaney 1992) as legitimate business strategies. It involved a broader shift in property relations that helped redefine who has a claim on the income produced by the corporation (Fligstein 1996: 658). However, as noted before, the problems facing American corporations, the shift in property relations, and the general logic which structure these organizational fields must be understood in relation to the antagonism between labor and capital that is at the heart of capitalist production.

Chapter 5. Conclusions

Summary

The growth of corporate debt is one of the key indicators of financialization at the firm-level. In the financialization literature, this trend is usually associated with the rise of the SV approach to firm governance, which recommends the substitution of debt for equity as a method to “discipline” managers and reduce the agency costs associated with “excessive” future cashflow. The alternative hypothesis presented in this dissertation argues that corporate debt can be better understood as a method to discipline workers. By committing in advance the future income of the corporation to their debtholders, managers are able to circumvent wage demands from unions and strengthen their position in the process of collective bargaining. This practice undermines the bargaining position of workers and contributes to rising income inequality.

In Chapter Two I presented initial evidence supporting this hypothesis in the form of a specialized scholarship within financial economics that points to such strategic use of corporate debt (e.g. Bronars & Deere 1991; Dasgupta & Sengupta 1993; Perotti & Spier 1993; Hanka 1998; Klasa, Maxwell, & Ortiz-Molina 2009; Matsa 2010; Benmelech, Bergman, & Enriquez 2012; Schmalz 2018; Woods, Tan, & Faff, 2019). These scholars are not interested in questions of income inequality or the power of organized labor, but in identifying potential determinants of corporate capital structure. They argue that the labor relations within the firm serve as such determinants, pushing managers into increasing the level of corporate debt to counter attempts of unionization and reduce “excessive wage”. In other words, these financial economists take the existing labor relations as an explanatory variable and the level of corporate debt as an outcome variable. Nevertheless, their theoretical discussions and empirical results confirm the central thesis of the present dissertation regarding the use of corporate debt as a negotiation device to

extract wage concessions from workers.

To be clear, I use this financial scholarship on capital structure not as a secondary source, nor as part of the academic literature relevant to the research of financialization and income inequality. Rather, I treat these studies in the same way that the scholarship on the SV approach treat the works of agency theorists. That is, I view them as an integral element of the developments reviewed in the dissertation, the growing importance of financial assets and the related shift in property relations reviewed in the following chapters. Thus, it is important to note that economists first started to note the strategic possibilities of corporate debt round the same time that concession bargaining became widespread in the U.S. economy, and that the first studies on corporate debt and labor relations were published in the early 1990s, and focused on the same period covered in Chapter Four of this dissertation.

In Chapter Three I turned to examine the historical developments that enabled this strategic use of corporate debt. Here I offered a reinterpretation of the shift toward finance in the U.S. economy from a class perspective. I argued that the “war on inflation” waged by the Federal Reserve under the leadership of Paul Volcker can be better understood as a form of class warfare, as it sought to bring inflation under control by holding down wages. I suggested that this restrictive monetary policy can be understood as part of a broader shift in property relations that reflected the growing importance of financial assets as a form of property. I showed that inflation was especially problematic to the owners of financial assets, as rising prices eroded the value of their property, depressed the prices on the stock exchange and drove investors away from market. These concerns were articulated by the famous investor Warren Buffet (1977), who complained that “inflation is a far more devastating tax than anything that has been enacted by our legislatures” (p. 253). It was the same concern that led Wall Street to pressure President

Carter to nominate Volcker as the chairman of the Federal Reserve, a decision that was received on the stock exchange with sharp rise in prices the day it was announced (Facts on File World News Digest 1979).

I continued to identify two aspects of this shift in property relations that played an important role in the transformation of debt into a negotiation tool. First, the incorporation of CRAs into the regulatory framework of financial sectors since the mid-1970s provided a focal point for other actors in financial markets, as credit rating increasingly served as a coordination mechanism that bolstered the disciplinary role of corporate debt. This is because downgrading the rating of corporate debt can prompt the sale of bonds by investors, making borrowing more expensive for the already-distressed corporation. I also noted that in the methodology used by CRAs to evaluate this rating, “lower and more flexible” labor costs improve the “creditworthiness” of the firm (Standard & Poor’s 2013: 64). Second, I argued that the Bankruptcy Reform Act of 1978 was essential for the practice of strategic bankruptcy, which became more and more prevalent since the early 1980s. The reform act created chapter 11, which paved the path to strategic bankruptcies by allowing solvent corporations to file for bankruptcy to reorganize their debts. The new chapter strengthened the power of existing management and shareholders in bankruptcy proceedings (LoPucki 1993), but it also increased the influence of large creditors on the reorganization of distressed firms (Posner 1997). At the same time, the reform had a negative impact on organized labor, as it allowed corporations in chapter 11 to unilaterally reject existing collective agreements. The legal logic was that collective agreements are executory contracts that have not yet been fully executed. The legal reasoning here shows again the growing importance of financial assets as a form of property. As Chapter Two notes, these assets are basically contractual claims between two parties. In the case of corporate finance, these parties are the

corporation on the one hand, and the owners of corporate stocks and corporate debt (loans, bonds, commercial paper) on the other hand. These contracts provide their owners with the right to receive future income from the corporation. The Bankruptcy Reform Act was designed to protect this right by allowing corporations to reorganize their debts before dissipation of their assets (Pasvogel 1980; Posner 1997). It has done so, among other things, by sacrificing the contractual rights of trade unions.

Chapters Two and Three provided the theoretical basis and historical context for Chapter Four, which contains the core empirical research of the dissertation. Here I explored how corporate debt became an effective negotiation tool within processes collective bargaining processes during the economic recessions of the early 1980s. For this purpose I shifted to a higher resolution, tracing the strategic use of corporate debt in the U.S. auto, steel, and airline industries. I showed that although the impact of the economic downturn was strongly felt across the economy, each of these industries also faced its own set of unique problems. In the auto industry, these included high oil prices that gave an advantage to the more fuel-efficient cars of foreign manufacturers, and the need for increased investments to meet new government regulations. In the steel industry, decreasing demand due to the rising use of alternative materials and more efficient production techniques used by foreign manufacturers created a problem of overcapacity, driving steelmakers to diversify their activities through acquisitions that exacerbated their debt problems. In the airline industry, deregulation ushered in a period of cut-throat competition between domestic carriers, which eventually drove some firms to bankruptcy and provided the conditions for the wave of mergers that began around the mid-1980s. But despite the notable differences between the three industries and the specific problems they faced, in all of them the growing use of corporate debt as a negotiation tool followed a similar pattern:

it emerged first in financially distressed corporations that were actually facing possible bankruptcy, but quickly spread to more stable NFCs that took advantages of the economic situation to pressure workers into wage cuts and other givebacks. Corporate debt, as the chapter showed, gave managers an important leverage over workers and their unions, and was instrumental to the rise of concession bargaining during the period.

As the chapter showed, workers were far from passive or silent about the sustained efforts to cut wages and eliminate existing benefits. Unions rejected requests for early negotiations, demanded management would open its books, and brought in their own accounting firms to verify the financial situation of the firm. Even when unions leaders agreed to provide concessions, they often encountered strong resistance among the rank-and-file workers and their locals, for whom concessions meant “working in more hazardous conditions and abandoning aspirations to a respectable standard of living” (Brenner, Day, & Ness 2009: 234). As the concessions spread across firms and industries, union leaders became increasingly aware of management’s use of corporate debt as a negotiation tool. As we have seen, ALPA president Henry Duffy testified in Congress how meetings with management were scheduled to coincide with a visit from the airline’s creditors. By the mid-1980s, USW negotiators were refusing to provide further concessions to Wheeling-Pittsburgh unless its creditors would forgive part of its debt, and demanded they will be brought into the negotiation table.

No doubt, American NFCs were facing challenging economic conditions during the period, as their sales declined sharply and their cost of borrowing rose. But despite the recessions and their heavy debt burden, they continued to distribute handsome dividends to their shareholders, even when reporting huge losses. This is not too surprising, given that U.S. corporations were always reluctant to reduce their dividend even in the face of adverse conditions. As one report from the

U.S. Bureau of Economics (1977) to the Federal Trade Commission noted, “there is a quasi-fixed element to dividend payments as U.S. companies are loathe to suspend dividends” (p. 237). One possible explanation for this behavior is that changes in dividend policy “signal” to investors on future changes in corporate cashflow, and thus cutting dividends tends to lead to declining stock price (e.g. Bhattacharya 1979; Bernhardt, Douglas, & Robertson 2005; Dionne & Ouederni 2011). But it is also possible that top executives, who are often among the largest shareholders in the corporation, are not inclined to forgo the income accruing to them as owners of financial assets, especially when the decline in profits is reflected in their annual bonus. Regardless of the specific explanation, it is at least clear that managers could have used these funds to repay their creditors rather than enrich their shareholders. From this perspective, it can be argued that the concessions made by workers helped sustain the distribution of dividends just as much as they helped NFCs continue servicing their debts.

Class, property, agency

From the decline of the postwar era, through the economic problems of the 1970s, to the Volcker Shock and the subsequent recessions in the U.S. economy, the class struggle framework adopted in this research allows us to construct a coherent historical story that helps explain the impact of financialization on income inequality. If we view the problem of inflation as an external constraint on the U.S. economy, then the Volcker Shock and the shift in U.S. monetary policy appear as a rational economic solution from the perspective of the state, as Krippner (2011) suggests. And if we view this shift in monetary policy as an external constraint on the organizational field of American NFCs, then the demand for wage concessions can be explained as a rational response of corporate managers to changes in their organizational field, as implied in the scholarship on the rise of the SV approach (e.g. Fligstein & Shin 2007; Tomaskovic-

Devey & Lin 2013; Jung 2015). However, when we view the inflation of the 1970s as an expression of a social conflict, and understand the Volcker Shock as a form of class warfare, then the use of corporate debt as a negotiation tool seems more like a continuation of the same class struggle by different means, a successful strategy deployed by capital in its conflict with labor.

Empirically, the dissertation provides a more solid basis for two important claims in the emerging scholarship on financialization and income inequality. First, existing studies argue that holders of financial assets became increasingly powerful in their claims on the income generated in nonfinancial sectors (e.g. Tomaskovic-Devey, Lin, & Meyers 2015; Jayadev, Mason, & Schröder 2018). Chapter Three of the dissertation shows that this development is related to a broader shift in property relations that follows the rise of financial assets as a dominant form of capitalist property. Second, existing studies suggest that financialization helped undermine the power of trade unions (e.g. Palley 2013; Alvarez 2015; Lin 2016). Chapter Four of the dissertation describes how this development took shape in reality, using concrete examples from collective bargaining processes in three nonfinancial industries. These contributions go beyond Statistical testing to show how financialization contributes to income inequality “on-the-ground”, at the level of workers, managers, shareholders, and creditors.

The historically-grounded class analysis presented in this dissertation does not deny the insights provided by existing approaches in the financialization literature, with their emphasis on the potential conflict between managers and shareholders, or the diverging interests of finance and industry. Rather, it seeks to incorporate these insights into a broader perspective that can better account for the impact of financialization on the distribution of income. This perspective offers several advantages compared with the existing approaches. First and foremost, it provides a stronger explanation for the impact of financialization on income inequality. The existing

literature on financialization often views it as a response to the economic problems of the 1970s. These problems are viewed through the prism of corporate governance, as in the scholarship on the SV approach, or policymaking, as in Krippner's state-centered approach. In both cases, the impact of financialization on income inequality appears as a side-effect or unintended consequence. By reframing these economic problems in class terms, the present dissertation provides a more solid link between financialization and income inequality. When we view the economic problems of the 1970s as closely related to the escalation in the class struggle, it becomes clearer why financialization has had such a strong impact on this battlefield.

Second, the class struggle framework adopted in this research gives agency to labor, which is largely denied in the existing literature. Rather than being passive victims of developments they have nothing to do with, this dissertation shows that the impact of financialization on income inequality involved fierce conflicts throughout the U.S. economy, as workers and their unions fought to protect the gains achieved during the postwar era. That these battles ended in the defeat of organized labor should not lead us to ignore these efforts, or assume that financialization automatically reduced the wages of workers without any response. In other words, the dissertation points out that the impact of financialization on income inequality is the contingent outcome of the historical development of the class struggle between labor and capital.

Third, a class struggle framework reminds us that economic categories such as profit, debt, and wages are "only the theoretical expressions, the abstractions of the social relations of production" (Marx 1976: 165). In this sense, it is not so much that corporate debt, or financial assets in general, are "embedded" in social relations; they are in themselves a "form of appearance" of these social relations, or as Joseph (2014) suggests, part of "the broader social processes of exploitation and dispossession, an immanent component of social relations rather than an

external imposition” (p. 2). The interest and dividends they provide their owners are inversely related to the wages received by workers, on which they depend to obtain their means of subsistence. This relation remains hidden behind the contractual form of financial assets, obscured by the mediation of the corporation itself, and disguised by the technical division of surplus value into interest and profit. But as the present dissertation aimed to show, this relation is essential for our understanding of the impact of financialization on income inequality.

Suggestions for future research

The dissertation focuses on a specific development associated with financialization – the growth of corporate debt – and examines its impact on collective bargaining and the power of unions. In reality, however, the growth of corporate debt, like financialization in general, is enmeshed with other processes and developments, and can be isolated only in our mind and never in practice. Rather than an independent variable that exerts direct influence on the distribution of income, the analysis presented in this dissertation suggests that the impact of financialization on income inequality works in tandem with other important developments and processes that have taken shape in recent decades, most notably *globalization* and *neoliberalism*. Indeed, many scholars agree that the changes covered by these terms are also related. Some scholars view financialization as the driving force behind neoliberalism (e.g. Crotty 2003; Dumenil & Levy 2004; Orhangazi 2008), while others argue that financialization is the outcome of neoliberal policies (e.g. Kotz 2010; Palley 2013). Some scholars suggest that globalization contributes to financialization through the creation of global value chains (e.g. Milberg 2008), while others propose that financialization pushes globalization forward through increased liquidity and international capital flows (e.g. Stockhammer 2010; Baud & Durand 2012). Future research on financialization and income inequality can benefit from bringing into its analysis processes

commonly associated with globalization and neoliberalism as well.

While this dissertation focused on the U.S. economy, the insights it provides are likely relevant to other economies as well. As a recent negotiation guide from a British trade union states, “employers frequently use the burden of debt to argue that the company must cut costs, to increase cash flow and that therefore a significant increase in pay is unaffordable. What is not normally pointed out is that high levels of debt are often taken on in order to fund payments to shareholders through special dividend and share buybacks or to fund takeovers” (Unite the Union 2012). The impact of financialization on income inequality will likely vary between countries according to the specific development of the class struggle, property relations and other factors at a national level. However, the theoretical analysis of financial assets and the class struggle framework deployed in this dissertation can be equally useful in such future research.

Alongside the core empirical research, this dissertation offers several other contributions that can advance our understanding of financialization and its impact on income inequality. Starting from the proposition that financialization reflects the growing importance of financial assets as a form of capitalist property, Chapter Two offered a theoretical analysis of this type of property.

Focusing specifically on corporate stocks and debt, the analysis showed that the social relations that operate through these instruments are ultimately based on the social relation between capital and labor, and in this sense presuppose its existence. At the same time, I have argued that the specific form of these financial assets – which represent contractual claims on the future income of the corporation – opens up new strategies and courses of action within this ongoing class struggle, of which the use of corporate debt as a negotiation tool provides only one example. Future research can focus on other related strategies. For example, the dispersion of stock ownership, which gives rise to the potential conflict between managers and shareholders, also

means that each shareholder is less exposed to the risks associated with any individual corporation, since they hold a diversified portfolio which included stocks in various firms (Peress 2010). Thus, the dispersion of stock ownership increases the resilience of the capitalist class as a whole. The liquidity of this type of property, to mention another example, enables the owners of this type of property to convert it back into cash simply by selling it on the relevant market. This ability means that shareholders and bondholders can quickly withdraw their money in response to any strike threats or the slightest sign of labor militancy. Indeed, evidence of a relation between labor disputes and stock trading can be easily found in the financial media.¹¹

¹¹ Some recent examples: Owusu, T. (31 May 2018), *Casino stocks fall as union strike deadline approaches*, TheStreet. Retrieved from: <https://www.thestreet.com/investing/stocks/casino-stocks-tumble-as-union-strike-deadline-approaches-14607224>; Riley, C. (1 October 2018), *Ryanair's strikes are hitting its profits and stock price*, CNN. Retrieved from: <https://www.cnn.com/2018/10/01/investing/ryanair-profit-warning/index.html>; Meijer, B. H., & Kar-Gupta, S. (17 August 2018), *Air France-KLM shares fall, Dutch pilots threaten to strike*, Reuters. Retrieved from: <https://www.reuters.com/article/us-air-france-klm-ceo/air-france-klm-shares-fall-dutch-pilots-threaten-to-strike-idUSKBN1L211I>; Klein, M. C. (13 February 2019). *What rising labor militancy means for investors*. Barron's. Retrieved from: <https://www.barrons.com/articles/rising-labor-militancy-threatens-municipal-bonds-more-than-stocks-51550076440>

Data Appendix

The dissertation employs a variety of data sources, both quantitative and qualitative. In what follows I discuss these sources and the calculation presented throughout the dissertation in greater details than afforded in the relevant chapters.

Chapter Three

The macroeconomic data presented in Chapter Three is obtained from various public sources. Data on strike activities and workers participation is taken from the U.S. Bureau of Labor Statistics (BLS). Data on annual inflation is obtained from the World Bank. The ratio of corporate profits to workers' compensation is calculated from data in *Section 6 – Income and Employment by Industry* in the National Income and Product Accounts (NIPA), published by the U.S. Bureau of Economic Analysis (BEA). Data on corporate profits is obtained from *Table 6.16B. Corporate Profits by Industry*, and data on employees compensation is obtained from *Table 6.2B. Compensation of Employees by Industry*.

Price-to-earning (P/E) ratio for S&P 500 companies is obtained from the webpage of Yale economist Robert Shiller, at <http://www.econ.yale.edu/~shiller/data.htm>. P/E ratio is based on the composite price of S&P 500 stocks over a trailing twelve month “as reported” earnings of all companies included in the index.

Chapter Four

Chapter Four of the dissertation presents the Debt-to-Equity (D/E) ratio for U.S. Nonfinancial Corporate Sector, and the Auto, Steel, and Airline Industries. D/E ratio is calculated by dividing the total liabilities at the industry level by the total shareholders' equity in the industry. D/E ratio is related to a firm's capital structure. i.e. the combination of debt and equity used by a company

to finance its assets. The relation between D/E ratio and the capital structure of the firm (or industry) is given by the basic accounting equation:

$$\text{Liabilities} + \text{Equity} = \text{Assets}$$

This equation states that the value of the total assets owned by the firm must be equal to the value of its total liabilities plus the value of its shareholders' equity. This equation is considered the foundation of the double-entry accounting system, as it ensures that the balance sheet is indeed "balanced" (equity appears on the liabilities side). The term "equity" as it used here should be distinguished from the term "equity" as it is applied to the corporate stocks held by shareholders. While the value of the stocks held by shareholders is determined through the trade on the stock exchange, the value of shareholders' equity as it appears on the balance sheet represent the difference between total assets and total liabilities (Equity = Assets – Liabilities). In other words, the shareholders' equity as it appears on the balance sheet is not an actual amount of money at the disposal of the firm, but reflect the fraction of the value of its assets that can be attributed to its shareholders. Thus, a firm can have negative shareholders' equity if its total liabilities are higher than the value of the total assets it owns.

The most detailed source on the balance sheet of U.S. industries is the *Corporation Income Tax Returns Report* published annually by the IRS. Unfortunately, the most detailed level on the report is still too broad for the purpose of the present dissertation. The auto industry, for example, is included within "Motor Vehicles and Equipment", the steel industry is part of "Primary Metal Industries", and the airline industry is include in "Transportation". To present more accurate measure for the industries reviewed in the dissertation, I relied on other available sources. For the auto and steel industries, D/E is presented as reported by the U.S. Department of Commerce (1985a, 1985b) as part of its *Studies in the Economics of Production* series. For the

airline industry, D/E is calculated from the balance sheet of major U.S. carriers as they appear in the *Air Carrier Financial Statistics*, published annually by the Civil Aeronautics Board reports until 1984. For comparison, I present below additional measures of D/E calculated from alternative sources, which cover broader industrial divisions.

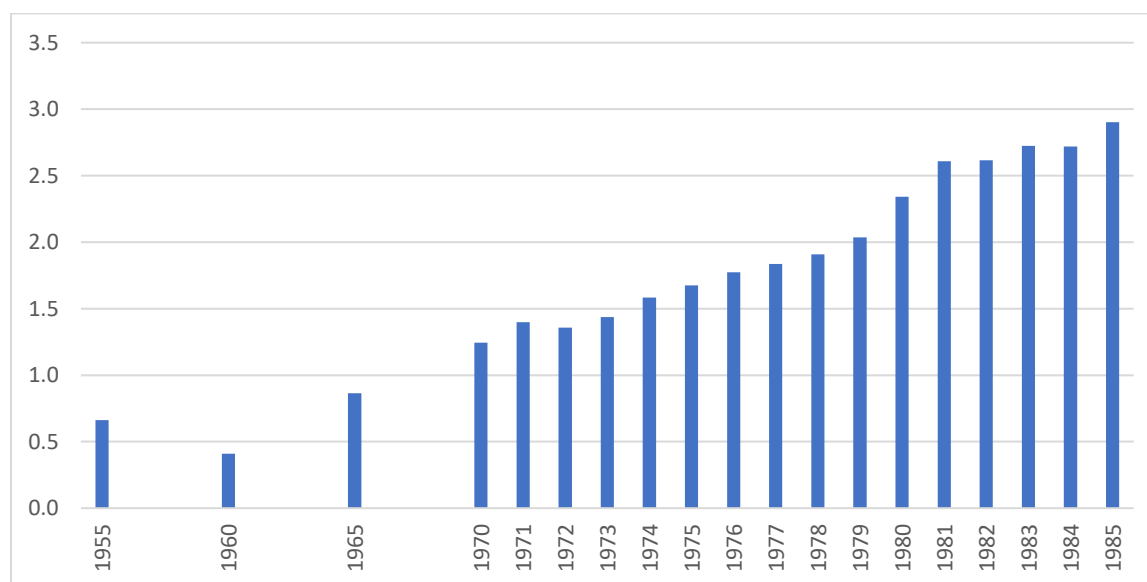


Figure 6.1 Debt-to-equity ratio in the motor vehicle and equipment industries

Source: Own calculation based on data from the Corporate Income Tax Returns reports, IRS

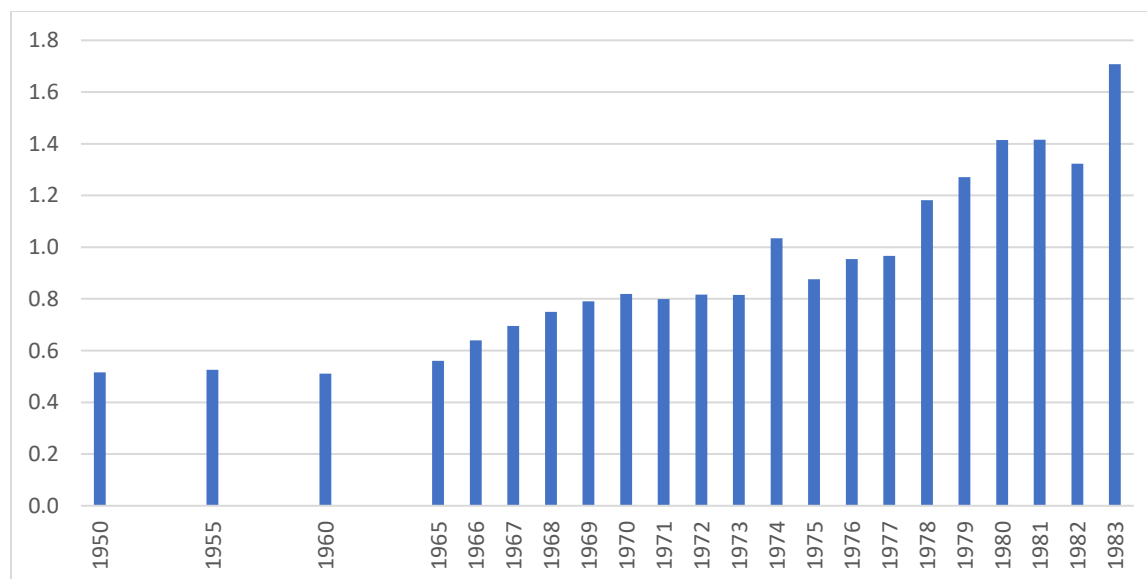


Figure 6.2 Debt-to-equity ratio in the iron and steel industries

Source: Own calculation based on data from the Statistical Abstract of the United States

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