Organization Management Journal

Volume 7 | Issue 4 Article 9

12-1-2010

# “The Rise and Fall of Finance and the End of the Society of Organizations” by Gerald F Davis (Academy of Management Perspectives, August 2009)

Frank M. Werner
*Fordham University*

**Organization Management Journal (2010) 7,** 307–309


Recent Research of Note

# "The Rise and Fall of Finance and the End of the Society of Organizations" by Gerald F Davis (*Academy of Management Perspectives*, August 2009)

Summarized and Interpreted by Frank M Werner

*Fordham University, New York, USA*

*Organization Management Journal* (2010) **7,** 307–309. doi:10.1057/omj.2010.41

In the last half-century, the USA, and indeed much of the economically developed world, has experienced a major transition from an industrial society to a postindustrial society in which employment has shifted from manufacturing to service industries. Davis chronicles this shift and argues that the transition was largely shaped by the parallel evolution of finance. He then points to the recent economic crisis as evidence that this new finance-centered society has failed to provide a viable alternative to the social stability that characterized its predecessor, and that our models are too old to cope with the economic and social problems we currently face.

The evolution Davis describes developed in the USA, and subsequently in most of the economically developed world, over the past 40 years. When Daniel Bell wrote *The Coming of Post-Industrial Society* in 1973, the USA was the only country with the majority (60%) of its employment in services industries. Today, the transformation in the USA is nearly complete: less than 10% of the US labor force works in manufacturing or agriculture, and the number continues to decline. Although the offshoring of jobs to lower-wage environments accounts for some of the change, the primary driver has been the rapid growth of manufacturing productivity due to improvements in information and production technologies. The USA leads the world in manufacturing value added, but it is due to capital investment and not increased employment.

This article summarizes the argument made by Davis in his book, *Managed by the Markets: How Finance re-shaped America* (2009). The article is organized into seven sections that mirror the flow of his book.

1. The arrival of postindustrial society – As employment has shifted from manufacturing to services, the social contract between employer and employee has also shifted. Manufacturers needed large labor forces that often had to work under difficult conditions. This led to the formation of labor unions, and those companies that wanted labor peace and productivity soon learned to accommodate. During World War II, companies

found themselves competing for a limited supply of domestic labor; to attract employees they improved working conditions, developed benefits packages, and increased job security. Their large size offered room for advancement, and most employees, tied to their companies by non-portable pensions, stayed for life. As Robert Reich observed in *Supercapitalism* (2007), an unwritten national social contract was established in which the government permitted the existence of oligopolies in most large industries in return for labor peace and for the companies providing most of the social safety net as part of employment. Today, the largest employers are service companies that do not have the implicit protection of government-approved oligopoly status and must compete intensely with foreign companies with low-cost structures. Wages and benefits, especially for those employees who are not in jobs that require highly specialized training, have declined or have been eliminated. Job security has all but vanished. The workplace is smaller and flatter with limited room for advancement, and, with pensions gone or portable, there is no reason for employees to remain with one employer any more.

2. The rise of institutional investment – The shift from defined-benefit pension plans managed by employers to defined-contribution plans managed by individuals led to the dramatic growth of mutual funds in the 1980s and 1990s. Whereas 6% of US households invested in mutual funds in 1980, the number had grown to 45% by 2008. By 2001, over 50% of US households owned stock, either directly or through pension plans. This shift further loosened the ties of employee to employer and had the effect of shifting pension risk from the employer (how much to fund to meet the defined benefits) to the employee (how to invest to reach retirement goals). Hence, as employment became less concentrated, corporate ownership became more concentrated. Interestingly, although a few mutual funds invest the majority of pension monies, they have not used their power to be activist shareholders, perhaps because the companies whose stock they hold are also their customers.
3. The ascendancy of shareholder value – During the past 40–50 years, shareholder value maximization has become the principal goal, and sometimes the only goal, of most publically-held companies. There have been many consequences: the rise of the financial media, the celebrity of financial executives and analysts, the tying of executive compensation to share price and the associated development of executive stock options, and the growth of outsourcing to perform each business activity at the lowest cost. Davis argues that today's focus on share price is both a consequence and a cause of modern corporate structure – a consequence because the equity markets value different structures differently, and a cause because executives adopt strategies and structures based on their anticipation of the market's reaction. As a result, today's corporation is shaped as much by the "cognitive capacity of Wall Street" as by more traditional considerations.
4. Securitization and the changing nature of banking – As banks applied the outsourcing model to their businesses, they realized that it was far more profitable to construct a financing package and sell it to investors than to hold on to the investment themselves. Supported by advances in information technologies and valuation methodologies, and fueled by the need of mutual funds to invest their increasing share of pension investments, this led to securitization where almost any cash flow stream could be packaged and sold. Commercial banks and investment banks adopted the same business model, supported by legislation that removed the barriers each had previously faced to engage in the other's activities. The profitability of the financial sector enticed industrial companies such as GE and Enron effectively to become banks. And, the need to compete for ever larger deals encouraged banks to merge. As smaller, locally based banks disappeared, many cities lost important business and civic centers.
5. The changing role of the state – Governments have also adopted today's business models. Many have embraced outsourcing as a way to hold down costs. The US government now employs more contract workers than federal employees, which has led to the potential for divided loyalties – share price versus the public good. Smaller governments have enacted legislation designed to support their "core competencies": Bermuda as a home for insurance companies and intellectual property, the Cayman Islands as a home for hedge funds, Tuvalu for its national Internet domain suffix, Liberia as a home for ship registry.
6. The impact on households – The shift from reliance on an employer to reliance on the

financial markets has changed individuals' understanding of their place in society. We are no longer organization men but daytraders who evaluate our activities as investments. Even the language of relationships has changed to mirror this shift. We now "invest in our human capital" when we go to school and "invest in our social capital" when we get together with friends. Increased housing prices and the availability of home equity credit lines have remade the household budget with a focus on financial market values. And, all but those whose jobs involve a personal touch, such as personal fitness trainers, are now subject to employment volatility since their work may easily be outsourced.

## Implications for managers and researchers

7. In the seventh section, entitled "Moving forward," Davis summarizes his thesis and discusses its implications. "The agenda for management scholars going forward should be to help create institutions that serve the needs for economic security and health care formerly addressed by the old system, while building new opportunities."

- The society of organizations is gone, replaced by a portfolio society in which personal welfare depends increasingly on the financial markets. This shift amplified the recent economic downturn as changes in housing and investment values affected behavior more than it would have previously. New models of these relationships are needed to guide policy and business decision making.
- With the demise of the social role of corporations, new theories are needed of business organizations and their relationship to the state of politics, social class, the family, economic mobility, racial and gender inequality, etc.
- Governments' ability to use corporations as vehicles for social policies (EEOC, OSHA, ERISA) has changed. New mechanisms are yet to emerge, leaving governments impotent with respect to important social issues.
- Theories of asset specificity, vertical integration, multi-divisional structure, make-or-buy decisions, and corporate boundaries are based on company forms that now represent a small fraction of US business. New theories, relevant to a service economy, are required.
- Finance-based theories of the firm are incomplete or make assumptions not supported by the evidence and will not replace management-based theories. Many corporations will look for a goal beyond shareholder value maximization.
- More research into political economy is required following a period in which government played a large role in restoring business confidence, supporting the financial sector, and preventing companies deemed "too big to fail" from failing. More research into mixed economies considering a variety of roles for government will be necessary.
- The financial services industry and the shipping industry merit greater study because of their central role in the new global economy.

## References

Bell, D. (1973). *The coming of Post-Industrial society*. New York: Basic Books.
Davis, G.F. (2009). *Managed by the markets: How finance re-shaped America*. New York: Oxford University Press.
Reich, R.B. (2007). *Supercapitalism*. New York: Alfred A. Knopf.

## About the author

**Frank M Werner** is Associate Professor of Finance and Business Economics at the Fordham University Schools of Business in New York City. His bachelor's degree is in Engineering and Applied Physics from Harvard College, and he earned an MBA degree from Harvard Business School and a PhD in Finance from Columbia University. An award-winning teacher and the lead author of two textbooks, he has been studying the evolution of finance theory and practice for more than 20 years. His current work is on the connection between finance and the evolving needs of society, often referred to as "global sustainability," a subject he explored in his new novel, *The Amazing Journey of Adam Smith*. He can be reached at fwerner@fordham.edu.