Private Equity Firms and the Irrelevance of Traditional Monopoly

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Alfred Marshall wrote in the preface to his *Principles of Economics*, "economic conditions are constantly changing, and each generation looks at its own problems in its own way" (Marshall, 1946: v). Indeed every generation of scholars should ask new questions, look at problems from different perspectives and evaluate the efficacy of any theoretical framework.

Unfortunately, neoclassical economics has hermetically sealed itself from honest self-evaluation; it remains "ahistorical, developing models that abstract business organizations, their debt dynamics and the state of the macroeconomy" (Rima, 2002: 409). Its core propositions are accepted as faith and cannot be challenged empirically. The model of perfect competition and monopoly, for example, which forms the core of the neoclassical theory of the firm remains beyond empirical challenge[1] even though it is "a myth, only valid in the theoretical framework of static equilibrium theory and not in real life" (Ekeland, 2005:1). Unfortunately, fixation with mythical concepts has obfuscated understanding of the most important phenomena of our time – the growing financialization and centralization of capital. Nine of the largest twenty-five global corporations are financial institutions,[2] collectively earning 12.7 trillion dollars in revenue in 2006 (Fortune, 2007). Capital exports are increasing more rapidly and are more significant than export of goods/services at 16 percent of world GDP in 2005. In the United States finance, insurance, real estate, rental and leasing comprises 21 percent of total GDP. (Howells and Barefoot, 2007: 19). As Grogan notes, "in today's world, banks own insurance companies, pension funds and hedge funds. Insurance companies own banks. Brokerage houses own commerical banks and hedge funds — and so on and so forth" (2005: 15).

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1 Nevertheless, the logical consistency of the neoclassical model has been challenged. See (Reardon 2006).

2 These include: #13 ING (Netherlands, 158 billion in revenue), #14 Citigroup (USA, $146 billion), #15 AXA (France, $139 billion), #18 Credit Agricole Bank (France, $128 billion), #19 Alliance (Germany, $125 billion), #20 Fortis (Belgium, $121 billion), #21 Bank of America (USA, $117 billion), #22 (HSBC, $115 billion), #22 AIG (USA, $113 billion), #25 BNP Paribas (France, $109 billion).

The purpose of this paper is to analyze one aspect of financialization –growth of the private equity firm, which is quickly “becom[ing] the most voracious acquirers of assets globally” (Dixon, 2007: C12). We must redirect focus away from mythical conceptions to understand the real foundations of out economy. The first section of this paper will offer a primer on private equity. The second section will briefly critique the neoclassical conceptualization of monopoly. The third will incorporate the private equity firm into heterodox microeconomics. The fourth will offer concluding comments.

A Primer on Private Equity Firms

Private equity firms use a combination of equity and debt to access private pension funds, insurance companies and endowments to invest in companies that are not traded publicly. Given escalating increases in stock prices, leveraged buyout options (LBOs) of entire firms are more expensive, making partial acquisition more palatable. Non-core assets are sold to lower debt ratio, improve cash flow and invest in technology to increase investment returns before selling them three to five years later, either publicly or to another investor. If all goes as planned, the private equity firm reaps enormous profits, investors are rewarded with high returns –more than double the Standard & Poor 500 index– management earns exorbitant salaries and the new company operates more efficiently (Candaele, 2007: 2). High investor returns explain the eagerness of pension funds and other institutional investors to lend, which have historically earned flat returns. In 2005, public pension funds invested a record 1.6 percent of their portfolios in venture capital and private equity, a significant increase since 2000, representing well over 2 billion in assets.

Private equity firms have recently purchased Equity Office Properties, America’s largest office building landlord; HCA, America’s largest hospital chain, Harrah’s, the world’s largest casino company; Chrysler, the third largest automobile firm in the United States; and Aramark, one of the largest cleaning and food service companies. In addition, well-known firms, Houghton Mifflin, Quantas Airlines, Neiman Marcus, Toys R Us, Clear Channel, Kinder Morgan, Hertz Rental have all been purchased by private equity firms.

In 2006 private equity firms purchased 1010 companies compared to 324 in 2001. In 2005,

for the first time, more money was invested into private equity than into stock mutual funds. Last year saw the largest private equity purchase - a $48 billion acquisition of TXU, a Texas based utility, by the private equity firms Texas Pacific, Kohlberg Kravis, Roberts and Goldman Sachs. Just like the monopoly trusts of the 19th century, private equity firms are transforming the contours of the American economy and "almost no company is beyond their reach forcing public companies to spin off assets, rethink portfolios and overhaul their balance sheets" (Rosenbush, 2007).

Great Britain accounts for 40 percent of all European private equity deals, and is second only to the United States. Of the top 50 private equity firms, accounting for 1.2 trillion of the $1.6 trillion in deals since 2002, only one – Pacific Equity Partners, from Sydney Australia, is located outside North America and Europe (Deloitte, 2007). Nevertheless, according to Deloitte, as the industry matures, we can expect expansion into new markets such as Asia and India, especially China. With over $1.2 trillion dollars in foreign exchange reserves, China this year invested $3 billion in Blackstone, the fourth largest private equity firm in the United States (*The Economist* May 26 2007, pp. 79-80). According to *The Economist*, "it is widely believed that by having China as a partner, Blackstone will receive preferential access to China's markets as well as providing China with experience it clearly needs [setting] up its own domestic private equity industry."

A preponderant argument in favor of private equity firms is that, like their conglomerate predecessors of the 1960s, they add value by encouraging companies to deploy capital more effectively (Dixon, 2007). Private equity firms discipline undervalued companies, thereby forcing them to revamp decision making, thus abetting the market. From the supply perspective, by earning higher rewards, pension funds become better-funded, decreasing the chance of government bail-out (Candaele, 2007: 2).

On the other hand, several criticisms of private equity firms exist. First, since financial managers are under pressure to produce results quickly – they earn huge pay packages if the turnaround succeeds, or face abrupt dismissal if the status quo continues – they might undertake unnecessary risks unpalatable to ordinary managers. Indeed management in publicly trade firms does not have the same incentives as private equity owners to pursue drastic change (Sorkin, 2007: 10). Second, focusing on a quick turnaround detracts from a longer-term focus, while the objective of making money displaces the objective of making goods and services (Foster, 2006:10). Third, company debt burden is increased, which decreases income. Fourth, the growth of private equity firms underscores the increased leverage of institutional investors – overseers of pensions, mutual funds and other financial assets. Money fund managers force corporations to focus on the growth of stockholder value; thus they have strong incentives to support organizational changes promised to boost near-term value (Whalen, 2002: 402). Fifth, given high levels of debt, such acquisitions are risky and more susceptible to higher interest rates, which in turn, can decrease profits and increase the firm's debt to income level, leading to insolvency (Rima, 2002: 412).

Despite claims by labor that private equity firms are destroying jobs, evidence to date is inconclusive. Although few studies have analyzed the most recent boom, preliminary evidence indicates that firms have at least marginally improved the businesses they own (Sarkin, 2007: 10). In a study of several buy-outs conducted at Nottingham University in Britain, employment levels initially decreased after acquisition, but then rose significantly over the subsequent five years" (A Private Power Play 2006: 2). A study by Edith Hotchkiss of 176 companies acquired since 1960, found an overall positive outlook (Sorkin, 2007: 10). And according to *The Economist* "the claim that private equity destroys jobs. . . is hard to stand up" (2006: 2). Nevertheless, more research needs to be conducted on the long-term effects of ownership change on jobs.

The Inadequacy of the Neoclassical Conception of Monopoly

During the late 19th century, in an effort to become scientific, neoclassical economics abstracted from history, and ignoring significant economic social, cultural and technological changes – "the most the world has ever seen" (Dowd, 2004: 81) retreated into a fairyland of make-believe assumptions to quickly become "the science of economizing, maximizing and efficiency . . . [thus serving] as a theory for working within and preserving the status quo" (Dowd, 2004: 83).

While neoclassical economics refined its mathematical technique, becoming more esoteric and abstract, capitalism evolved, ironically with a carte blanche from neoclassical economics, based more on ignorance than understanding. Advanced capitalist economies underwent intense centralization and concentration: Stronger companies gobbled up weaker ones, joining together in trusts, cartels, and holding companies aimed at eliminating cutthroat competition while stabilizing price and output. Capitalists in core countries sought new markets and cheaper sources of raw materials in Africa and Asia. What had been the small-scale predominantly domestically-oriented capitalism of the 19th century became the monopolistically-controlled, imperialist system of the 20th century.

Unfortunately neoclassical economics became enamored with its mythical conception of perfect competition and monopoly, unable and unwilling to examine the changing economy. Neoclassical economics borrowed Aristotle's conception of a monopoly – a market dominated by a single seller (Schumpeter, 1954: 60-1) and molded it to fit the contours of a mathematical, deductive edifice. It was Cournot's creation of elementary monopoly theory which was the first great triumph of mathematical economics. . . and it is not surprising that the endeavor to complete his work should have been an attractive occupation for his successors" (Hicks, 1979: 189).

According to neoclassical theory, perfect competition ensures an efficient allocation of resources, low prices and minimal profits, thus maximizing consumer welfare. A monopolist, on the other hand will produce less output at a higher price, redistributing resources from consumers to producers with an attendant deadweight loss. The fewer the firms in an industry, according to neoclassical theory, the greater the tendency toward monopoly.

Despite the paucity of real-world industries characterized by perfect competition and monopoly, neoclassical economics insists on teaching these myths since, "they are very useful models that have permitted economists to shed considerable light on the functioning of actual markets in the American economy (Mansfield, 1979: 165). Today, however, "the real power is not so much in corporate boardrooms as in the financial markets" (Sweezy, 1994: 10). Indeed, finance sets the pace and the rules for the management of the cash flow of nonfinancial firms (Foster, 2006: 7).

Fixation on the mythical conceptions of monopoly and perfect competition prevents neoclassical economics from understanding the benefits of increased economies of scale, while obfuscating the growing danger of centralization of resources, instead focusing on fewness of firms and industry concentration. This stems from the belief that market structure determines important performance variables such as output, price, cost and profit (Mathis and Koscianski, 2002: 323). Nevertheless, it is important to look beyond industry concentration and analyze the aggregation of capital in all its dimensions. Ironically, focusing exclusively at industry concentration will reassure that, ceteris paribus, private equity is beneficial since it leads to deconcentration rather than concentration.

A Place for Private Equity in Heterodox Microeconomics

Rudolf Hilferding coined the term 'financial capital' in his 1910 book of the same title, and today it means "the employment of money capital in financial markets and speculation more generally" (Foster, 2006: 12). It is accumulated money from past enterprise, savings from profits or wages, stored wealth available to finance new enterprise. This exchange – the past lending to the future, old money investing in new ventures is the crux of capitalism, the transaction across time that enables the creation of multiplying new wealth (Greider, 1997: 232).

For most of this century, finance and industrial capital were on more or less equal footing, with each jointly deciding where to invest and how to share the proceeds. As the global economy stagnated during the 1970s, however, the objective became to absorb the enormous economic surplus (Sweezy, 1994). The result was a financial superstructure sitting on top of the global economy . . . made up of banks and a host of dealers in a bewildering variety of financial assets and services all interconnected by a network of markets" (Sweezy, 1994: 7). This shift in economic activity from production to finance . . . is one of the main issues of our time (Foster, 2006: 1). In fact, " no one ever expected that speculative capital, a phenomenon as old as capitalism itself, could grow to dominate a national economy, let alone the whole world"(Sweezy, 1994: 2).

Like a hurricane needs warm ocean temperatures for energy, the financial system needs constant cash infusions to sustain itself. It is no coincidence that the financial superstructure has ascended with conservative economics, the latter empathizing unrestricted mobility of capital and free markets, designed to increase returns to capital. Furthermore, as regulatory oversight has waned, "potential benefits from manipulation and new financial innovations have also appeared" (Hake, 2005: 609).

Exploitation is necessary for the continuation of surplus extraction, obtained from the working population. . . suggesting the continuation of this system will only result in more surplus exploitation (Foster, 2006: 10-11). It squeezes the surplus from the real economy while magnifying the surplus several-fold. Neoclassical economics has deliberately obfuscated the existence of exploitation – taken as given by all the classical economists – by disingenuously assuming that factors of production receive the value of their marginal productivity (Dowd, 2004).

Recent history suggests that rapid increases in inequality have facilitated monopoly-capital finance. Financial innovation inflates the value of total assets while distributing income away from stakeholders (Hake, 2005: 608). Wolfgang Sachs and Tilman Santarius note "economic globalization scarcely correlates with a decline in international inequality, but rather with its deepening or, in the best of cases, with stagnation" (2007: 15). In the United States, home to more than three-fourths of private equity assets, the top 1 percent of Americans now receive their greatest share of income since 1928. Globally, although the number of people living in absolute poverty has decreased, inequality both between nations and within nations has increased. This is part and parcel of the trend toward increased financialization.

The role of the capitalist state has been transformed to service the financial sector. The Federal Reserve System's easy money policy and low interest rates since 2001 abetted the development of private equity firms, and remains ever-ready, along with the world's major central banks, to pump liquidity into the system at any sign of a major disturbance" (Foster, 2006: 10).

No existing economic theory adequately explains the current phase of monopoly finance (Foster, 2006: 12). Unfortunately, and not unexpectedly, mainstream theory offers little guidance, "it stands aloof from the world of fact, while students of mainstream economics learn nothing about the actual economy, instead acquiring a trained incapacity to comprehend economic realities" (Dowd, 2004: xiv). While heterodox economics has a rich tradition elucidating the macro implications of financialization, research needs to be directed to the microeconomic effects of private equity. What are the institutions that support the proliferation of private equity? What are the effects of private equity firms on other stakeholders? And how does the private equity firm use its power to affect the macroeconomy?

The entrance of private equity firms into the United States coal industry suggests a possible research agenda for heterodox microeconomics.[3] Coal, the stored capital of millions of years of solar energy (Freese, 2003: 6) is an

[3] The United States accounts for 17.8 percent of global coal production, second only to China's 40 percent. The US is the world's largest reserve owner, accounting for 27 percent of global reserves. In the United States, approximately 90 percent of coal is used for electricity; and conversely coal accounts for 50 percent of total US electricity production (EIA, 2007).

apt metaphor for the interrelationship between financialization, increased income inequality and global warming. Cheap and easy access to fossil fuels has fueled industrialization, increasing supply of goods and services faster than demand, underscoring the faltering ability of the world's consumers to keep up with new productive capacities (Greider, 1997: 233). Lack of access to fossil fuels has exacerbated and perpetuated poverty in many developing areas. While fossil fuel use has disproportionately benefitted rich countries, it has increased global warming, which in turn will disproportionately affect poor countries. One study predicts global warming could produce 50 million climate refuges by the end of this decade (Climate Change, 2007). Since the mid-1980s, the US coal industry has become more concentrated. In 1986, the top four coal producers accounted for 19.6 percent of US production; the top eight 30.3 percent and the top twenty 51.1 percent. Today, the two largest coal companies account for 30.9 percent of coal production; the top four account for 48 percent and the top eight 64 percent. Consolidation transfers leverage from consumers to producers and given strong demand it is not surprising that coal prices are at their highest level since the mid-1980s. In addition, the transformed coal industry was instrumental in electing George Bush to the presidency in 2000 (Freese, 2003:193- 94).

High coal prices in turn have attracted private equity firms and financial corporations into the industry. Peabody, the largest coal company, accounting for 12 percent of total US production, is owned by Lehman Merchants Banking Partners. Foundation Coal, the fourth largest US coal firm was formed in 2004 by the private equity firms First Reserve and the Blackstone Group. Alpha Natural Resources, the fifteenth largest firm was formed by the affiliates of First Reserve Corp, a private equity firm.[4]

Private equity firms want their firms to survive – at least until the IPO -- in order to profit from capital gains; at the same time, however, a short-term focus with increased debt might prevent the firm from implementing safe working conditions, since "the interest of the managers of a modern corporation need not coincide with the permanent interest of the corporation as a going concern" (Veblen, 1996: 157).

Topics of investigation in a research agenda within the specific context of the coal industry as well as a more generalized approach include: One, how does private equity ownership affect the leverage between

[4] International Coal Group, owner of the Saga mine, the twelfth largest US coal company, is controlled by the billionaire financial mogul, Ross Wilbur.

different stakeholders of the firm? Two, if studies corroborates that job loss is not a significant problem, what other mechanisms exist for the private equity firm to exert leverage? Three, does a tradeoff exist between health and safety, profitability and ownership? Four, how does private equity affect the political system? Five, conduct a time series analysis that extends beyond 3-5 years to ascertain the long-term effects on firm viability. Six, how can we better measure and define financialization, given that "there is no accepted way of measuring [its] full scale [with] numerous financial instruments exist[ing] outside traditional accounting definitions" (Foster 2006: 12). And finally does intense short-term focus on profitability and capital gains affect the long-term sustainability of the firm and/or other stakeholders?

Conclusion

Although neoclassical economics claims Adam Smith as "a spiritual elder" (Coyle 2007: 4) it ignores his most basic maxim,

> Servants, labourers and workmen of different kinds, make up the far greater part of every political society. But what improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable (1976, Book I, p, 88).

The objective of economics is to ensure adequate provisioning and living standards. Monopoly in all its dimensions interferes with the ability to provision and efforts to "improve the circumstances of the greater part."An essential first step in understanding the "problems of our generation" is to document the micro effects of financialization and its interrelationships to the macroeconomy, which is a more efficient use of intellectual resources than debating the mythical costs of monopoly. Specifically, investors influence government policy via bond interest rates and speculative trading in national currencies and extend their leverage in enacting business-friendly

policies both home and abroad (Peet, 2007: 50). This in turn influences the formation of private equity firms and firm behavior, irrespective of the presence of monopoly.

Research should address should we define control and regulate this phenomena so that the few don't benefit at the expense of the many, for as Minsky noted, "finance cannot be left to free markets" (1986: 292).

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"The basis of capitlaization has gradually shifted, until the basis is now no longer given by the cost of material equipoment owned, byt by the earning capacity of the corporoaration as a going-concenr," p. 137 Vebeln.

The effectuive business cpaitlaization is not ficxed permansetly and inflexibly by a past act of incocproateion or stock issue. It is fixed for the time being, only, by an ever recurring valuation of the company's properties, tangible and intangible, on the basis of their earning capacity." p. 138 Veblen.

The substantial foundation of the industrial corporation is its immzterial assets." p. 143 Veblen.