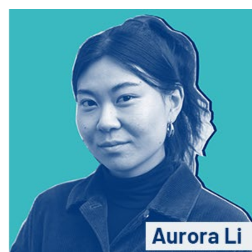
FINANCIALISATION: THE OVERLOOKED OBSTACLE OF A GREEN AND JUST TRANSITION

Executive summary

The financing of the green and just transition will require both private and public capital. In this context, some experts advocate that the role of governments should be focused on financial deregulation and the mobilisation of private finance to support the transition. In this paper, we will highlight the shortcomings of this approach by analysing more than three decades of European financialisation and offering policy alternatives.

There are three distinct reasons why we need to reset financial policy. First, even though the private sector has vast financial resources at its disposal, those funds are not being channelled into the necessary sustainable investments. Instead, publicly traded companies focus on short-term returns. They increase profit distribution while tangible investments take a back seat. Second, the financialisation of public services, such as healthcare and housing, has hindered rather than facilitated the transition. Private equity firms extract profits from essential sectors without adequately investing in long-term sustainability. The consequences include reduced service quality, increased debt levels and monopolistic market structures, all of which are propelling us further from achieving a just transition. Third, these phenomena have resulted in several decades of significantly rising inequality. Continuing down this path will likely further exacerbate this inequality and even jeopardise the political implementation of climate policies.

Instead of continuing down the path of deregulation, we should work towards resetting the financial system by means of strict conditionality for industrial policy, the regulation of financial actors, the promotion of socially sustainable investments and other measures aimed at reducing the negative impacts of financialisation and inequality on the transition.



This paper is published as part of 'Reset Finance', a project by Finanzwende and Finance Watch, supported by Partners For A New Economy.

Introduction

The green and just transition will require enormous amounts of capital. Most experts agree that the required funds will have to come from both the private and public sector. However, there is less consensus on how governments can establish a legal framework which ensures that private capital will contribute positively to the transition process. With restrictive fiscal rules in place, governments have focused on 'mobilising' private capital. The idea is to foster the transition by creating favourable conditions for the private sector to invest.

Unfortunately, little attention has been paid to the track record of these regulatory regimes in the past. To a great extent, regulation has required governments to bear all costs and risks, while the profits are privatised.[1] Such policies make it possible for windfall profits to be handed out to the private sector with no tangible benefits for the green and just transition. Conditionality in government programmes is often weak, as they rely upon financial intermediaries for implementation.[2]

This paper argues that the financialisation of our economy is an overlooked obstacle for the green and just transition. It analyses two distinct developments of financialisation in Europe: First, publicly traded companies, along with their focus on shareholder value, short-term profits and profit distribution, and second, private financial actors, such as private equity funds, and the effects of their involvement in the financialisation of public services, including housing and healthcare. It then argues that both phenomena have contributed to an increase in economic inequality, which is a massive roadblock for the green and just transition. The paper concludes with policy proposals that could help address this situation.

Profit distribution over investment

At a time when investment in sustainable and digital business models is so greatly needed, it is difficult to comprehend why private capital is often being distributed instead of invested. Public companies frequently choose to pay high dividends or buy back shares rather than make tangible economic investments. It is even more puzzling when these same companies continue to demand more government subsidies.[3]

Research has shown that companies tend to prioritise shareholder value and focus on short-term profits. According to studies on public companies throughout Europe, profit distribution is disproportionately high, while investment has either remained constant or is declining at a time when it should be increasing. **In the Netherlands, the dividends of public companies rose by almost 60 per cent between 2019 and 2022, while profits only increased by 36 per cent during the same period.**[4] In a similar manner, German DAX companies increased their profit distribution by 85 per cent between 2009 and 2020, although profits only grew by 48 per cent. In some cases,

profits were also distributed in years with economic losses.[5] And the distribution trend is continuing: In 2024, the German DAX companies are planning to repurchase more shares than ever before.[6]

Distributing profits reduces the funds available for investment, as a study of the largest companies in France convincingly argues: **If companies in the CAC 40 had paid out only 30 per cent of their dividends in 2018, the retained earnings would have covered the investment necessary for the ecological transition in that same year.[7]**

The financialisation of public services

In recent decades, restrictive fiscal rules and the belief in efficient private enterprises have led to a substantial number of privatisations in systemically important areas. The argument has been that private finance can bridge the funding gap and manage these enterprises more efficiently. Instead, financial actors have often altered the enterprise models to maximise short-term profits, a process of 'financialisation'.

The UK's water companies represent an excellent example of misguided financialisation. They were privatised in the late 1980s with the promise of increased efficiency and have since been restructured by various financial investors and loaded up with debt. Over the years, the financialised water companies have made headlines with concerns ranging from excessive water losses[8] to devastating environmental pollution.[9] **Thames Water, a private utility company that provides water services to 15 million households, has been facing insolvency due to over-indebtedness since mid-2023.[10]** Renationalisation of the company currently appears to be the only solution. However, this would require that the government take on the debt and thereby pay for the risky business model of the previous owners, who siphoned off high profits in the past.[11]

Hindering the just transition

Private equity firms have been a driver of financialisation for more than a decade with their distinct business model. Developed by private finance in the 1980s, they have since entered more and more economic sectors, including public services. Private equity firms pool money from investors, such as pension funds, sovereign wealth funds or wealthy individuals, in closed-end funds and primarily invest it by taking over privately owned companies (buyouts). However, their investment period is usually less than ten years, which means that profits must be generated quickly. This is why private equity firms rarely make essential contributions to the ecological transition, e.g. by providing long-term capital. With a focus on short-term returns, bought-out companies are 'financialised' according to criteria such as revenue maximisation, cost minimisation and a high return on equity.

Funded pension systems in particular promote financialisation by investing in private equity.[12] For example, **pension funds from not only Anglo-American countries but also European countries like the Netherlands,[13] Denmark,[14] Finland[15] and Sweden[16] have increased their investments in private equity firms in recent years in the hope of securing higher returns**.

For more than a decade, private equity firms have been acquiring companies in the public services sector across Europe and transforming them into financial assets - with negative social consequences. Profits are shifted to offshore financial centres, depriving the public of tax revenues.[17] It is an extractive business model that often targets publicly funded areas, such as elderly care, housing and healthcare.

Risks to healthcare sector

The COVID pandemic has highlighted an urgent need for investment in the healthcare and elderly care sector. For many years, the government has been withdrawing from these areas, paving the way for private finance. Investors are attracted to the potential for high yields in these crisis-proof sectors. However, the entry of financial investors has not led to increases in actual investment. According to research findings, private equity funds have instead extracted profits and accumulated debt.[18]

It is important to note that private equity funds do not generate their profits solely through company earnings. A large share of the profits is extracted via high rents and interest payments that their target companies have to pay. **In the UK, financial investors extract about ten per cent of the care sector's total annual income, using offshore financial centres to avoid taxation.**[19] Similar developments can be seen all across the European Union.[20] This system of profit extraction has severe consequences for the quality of services provided by the companies. For example, a Harvard Medical School study revealed serious health consequences for patients treated in private equity-owned hospitals in the US,[21] and a Swedish study showed that financialised nursing homes provide lower-quality services than homes with other forms of ownership.[22]

In recent years, doctors' surgeries have also become an attractive financial investment. In this sector, companies are also being loaded up with debt. Tangible investment takes a back seat after the buyout, while profits are often channelled to investors via offshore financial centres to avoid taxes.[23] High debts and a lack of equity lead to an increased risk of bankruptcies, as was shown in the US in 2023.[24] In addition, financial investors often form monopoly-like structures through their acquisitions, from anaesthesiologists in the US[25] to ophthalmologists in Germany.[26] These developments typically go unnoticed by regulatory authorities.

As financial investors increasingly focus on returns in the care and health sector, vulnerable groups are being directly impacted by the financialisation process. Financialised ownership often leads to a reduction in staff, which in turn results in decreased quality, as is evidenced by the numerous care scandals in countries like Spain[27], Germany[28], France[29], and the UK.[30] **The scandals surrounding nursing homes owned by private equity firms have involved inflated billing costs with substandard care,[31] malnutrition among residents[32] and elevated mortality rates.[33]**

Housing under pressure

Housing is increasingly becoming a socially charged issue. While the government and other non-profit providers have withdrawn over the years, financialised actors, such as listed companies and private equity firms, have stepped in.[34] In many cases, these developments have exacerbated social problems.

Between 2009 and 2020, the total volume of capital invested in European residential property rose by more than 700 per cent to over 60 billion euros annually.[35] In spite of this fact, the housing shortage has increased massively: Rents in urban centres have continued to rise, reaching record levels in some areas.[36] In this development, regulators are seeing severe overvaluation[37] that is further exacerbated by private finance, as shown in a recent study by the European Central Bank.[38]

To address the issue of limited affordable housing, governments are counting on large housing companies and financial investors to fund new construction projects,[39] although they have shown little interest in construction in the past. Vonovia, the largest housing company in Germany, with well over half a million units, built less than two thousand new flats in 2021, when interest rates were low.[40] The pumping of capital into the housing market by financial investors rarely leads to the construction of new houses. Instead, these investors often search for investment opportunities in existing real estate. The development of affordable housing is unattractive for these players due to their financialised business models.

Investors and listed housing companies strongly focus on short-term financial market indicators. In this context, investments in the residential sector, particularly maintenance and energy-related renovations, represent short-term costs and are therefore not a priority. As a result, **profits are distributed rather than invested: In 2021, 41 per cent of the rent paid to listed housing companies in Germany went directly to shareholders as dividends.[41]**

Federal tax privileges also contribute to the housing shortage by structurally favouring financial companies. In Germany, for example, individuals are required to pay property transfer tax when purchasing property, while companies can avoid this expense thanks to so-called 'share deals'.[42]

In France, harmful tax benefits for residential property caused a loss of eleven billion euros in twelve years. With this money, the government could have financed more than 70,000 social housing units. At the same time, the burden of housing costs for the poorest 25 per cent of the French population is twice as high as for the wealthiest.[43]

The track record of unregulated private finance involved in public services is rather bleak. Investors often prioritise profit extraction over value creation in healthcare and housing. These failed attempts have contributed to a substantial increase in inequality and should be treated as a lesson on how not to involve private financial actors in the transition.

Inequality, an obstacle for the transition

Inequality has increased substantially in the past few years. In 2024, global billionaires are 3.3 trillion US dollars richer than they were in 2020. At the same time, the poorest 60 per cent of humanity are 20 billion US dollars poorer.[44] There are numerous reasons why this trend is a problem for the green transition. For one, research suggests that **high inequality is linked to lower public support for climate policies**.[45] A direct link has also been identified between increased inequality and financialisation: Growth in the financial sector is associated with higher income inequality and a greater concentration of income in fewer households.[46]

These impacts have been particularly visible in the most recent crises and the policies used to address them. In the Global Financial Crisis, banks were rescued with public money. In this context, the banks' previous profits were privatised, while their losses were socialised. Subsequently, the increased government debt levels led to severe austerity throughout Europe.

During the COVID pandemic, the corporate and financial sector once again profited from generous crisis policies, such as asset purchase programmes by central banks.[47] Hedge funds[48] and banks recorded massive profits,[49] bank managers received large bonuses,[50] and shareholders were paid substantial dividends.[51] At the same time, thousands of workers throughout Europe were forced to reduce their working hours and suffer wage losses.[52]

Relying on unregulated private capital will likely further increase inequality, which could, in turn, jeopardise the political implementation of climate policies and even grow support for populist movements.[53]

Reset Finance

There is no question that private capital will have to play a significant role in the transition. However, as private finance continues to invest in fossil fuels,[54] there should also be no question that effective regulation is needed for their involvement. **In order to achieve a green and just transition, we need to reset finance.** The reset should employ a mix of measures, including but not limited to financial regulation.

- **Industrial policy** must set out clear conditions for government support. All forms of government aid, subsidies or risk sharing should be subject to conditionality. Dividend payouts and buybacks should not be allowed for companies receiving government support. As part of its Inflation Reduction Act, the US government has introduced a tax on share buybacks in order to curb this development.[55]
- To restrict the extraction of profits from public services by financial investors, a **payout distribution cap** could be introduced for specific sectors, either on a European or national level. An effective distribution cap prevents extractive practices while allowing companies to nevertheless achieve appropriate returns.[56]
- EU regulations for financial investors should be expanded. In its current form, the **Alternative Investment Fund Manager Directive** (AIFMD) focusses mainly on the protection of investors while neglecting to protect our economy. A fundamental revision of the directive could hold financial investors accountable for their risky business models. A key element of this amendment would be the introduction of liability rules for portfolio companies.
- The EU should extend the scope of the **global minimum tax** to include investment funds, which currently fall below a threshold. This change could put an end to their tax evasion.
- **National tax policies** should ensure the equal treatment of all types of investors. This change would require the abolition of national tax advantages for private finance, for example in real estate.
- When financial investors are in the process of acquiring a company, **national antitrust laws** should allow for government intervention at an early stage, especially when there is a risk of monopoly-like structures. Until now, national antitrust authorities have only been able to intervene when a single takeover exceeds a certain volume. However, market concentration often expands through multiple smaller acquisitions that are below the threshold. This is also why it is essential that all companies within an investment fund be taken into consideration when determining whether the threshold for an antitrust review has been met.
- The **EU Pension Fund Directive** (IORP) should be amended to enable direct long-term investment in projects that support a green and just transition. Investment strategies that focus on extracting profits in the short-term, e.g. private equity, should be prohibited.
- The **introduction of a social taxonomy** at the European level would help to direct investment towards projects with social value. This change would require a definition of activities that contribute to social objectives. At the same time, socially harmful activities would need to be reflected in the taxonomy. A social taxonomy of this kind would make it possible to identify and promote socially sustainable investments.
- For private capital to make a reliable contribution to the transition, **financial markets need to be stable**. To this end, fundamental European reforms would be necessary: e.g. the completion of the Banking Union, higher capital ratios, adequate liquidity instruments and the separation of commercial and investment banking activities.

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