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The U.S. Financial Sector's Value Added: Trends Now and Then

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The turmoil in the U.S. financial sector that began around August 2007 has fueled the current economy-wide recession. Indeed, many of the new economic policies to ameliorate the effects of the recession are directed toward financial institutions. To get a deeper perspective, we look back at the trends in the financial sector's total contribution to gross domestic product—or its value added—and the distribution of this income between labor and shareholders.

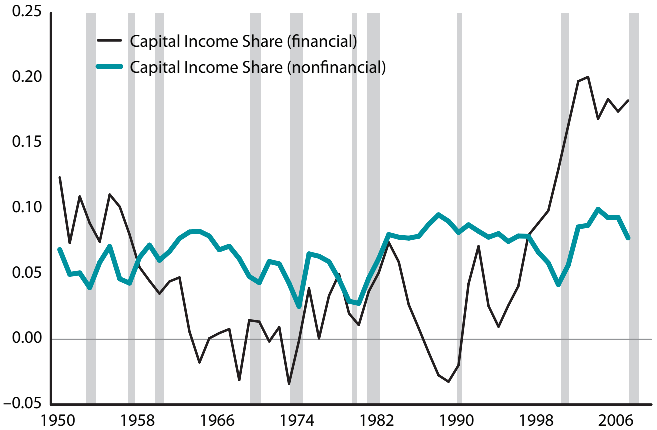
The "value added" of the financial sector measures the value of the services provided by this sector to the overall economy. We see a strong, sustained increase in the contribution of the financial sector's value added—as the most noticeable postwar trend in the ratio of the financial sector's to the nonfinancial sector's value added. This ratio changed from 1/20 in 1952 to 1/6 around its peak in 2006. This five-decade-long increasing trend culminated with a sharp 14 percent drop from 2007 to 2008.

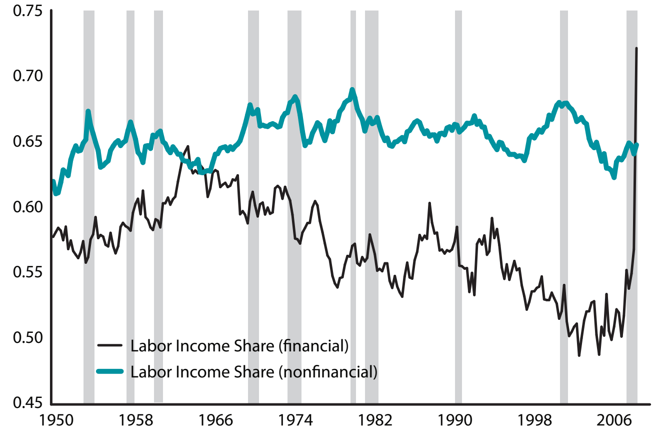
The fractions of value added accruing to labor and shareholders are summarized in the chart. (Data on value added accrued to labor are reported quarterly, whereas data on value added accrued to shareholders are annual.) National Bureau of Economic Research–dated recessions are shaded.

The U.S. financial growth between 1995 and 2006 certainly translated into record-high shareholder returns. Labor compensation returns were also dramatically high at the onset of the current crisis.

Shareholder income is the residual of value added after covering for labor costs, corporate taxes, and investment expenditures. The two most salient features of shareholder income in financial corporations are marked by wide shifts: First, shareholder income decreased dramatically during the early 1960s followed by a two-decade-long

Value Added Accruing to Labor and Shareholders





stagnation (in fact, this share fluctuated around zero from 1965 to 1975). Second, it experienced unprecedented growth from the mid-1990s to the present. By 2007, this share had risen to twice its previous high point. More than half of this increase can be attributed to lower investment and the remainder to increased profitability of the financial sector. Shareholder income (relative to value added) in the nonfinancial corporate sector declined substantially during the mid-1970s as well but has not displayed any specific trend since the late 1980s.

What about the share of total labor compensation in value added? As the right panel of the chart shows, in the financial sector this share tends to increase at the beginning of each recession (by 2.15 percent on average), only to drop by a larger amount (–3.8 percent on average) later in the cycle. The labor compensation share in nonfinancial corporations behaves similarly up to the mid-1980s. Since then recessions have instead been associated with a drop in the labor share of nonfinancial corporations. Perhaps most curious is that the labor share for financial corporations skyrocketed in the current crisis. It increased by 44 percent—from 0.50 in mid-2007 to a record-high of 0.72—by the end of 2008. Why such a big shift? Labor compensation did not change much while value added declined dramatically.

The U.S. financial sector increased substantially during the past five decades. Growth between 1995 and 2006 certainly translated into record-high shareholder returns. Labor compensation returns in the financial sector were also dramatically high at the onset of the current crisis. ■

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