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Junk-Bonding Industry

Fiction: Banks and stock markets finance capital formation to help companies grow and expand.

Reality: The stock market has become a vehicle for leveraged buyouts and corporate takeovers to load companies down with debt. This diverts profits away from being used for new investment while raising break-even costs, making financialized companies (and economies) less competitive.

The mythology of our time depicts the stock market as financing industry by providing equity capital—buying shares in companies, in contrast to interest-bearing bonds and bank loans. But companies have long been financing most capital investment out of retained earnings. Banks play little role in financing new plant and equipment, research and development. To top matters, the investment bankers who underwrite new stock issues and the hedge funds offering to buy out existing stockholders at a price gain seek to profiteer at the expense of industry more than help it. Underwriters, leading money managers and a new brand of corporate raider euphemized as "activist shareholders" take the lion's share of gains that occur after setting a low Initial Public Offering (IPO) price and then holding on for the jump that normally follows almost immediately. Companies normally receive only part of the market's valuation of their stock after a month, week or even the day of its issue.

The fact that this practice has been going on for over a century and has become worse rather than better shows that it is not an innocent pricing error by investment bankers who are supposed to know a reasonable price for a company. It is systematic deception by Wall Street, the City of London and other finance-capital centers. Governments play along with this exploitative financial fiction for their own reasons—headed by their support for the financial sector rather than industry.

It is hardly an innocent coincidence, for example, that the fraction of corporate value received by new stock issuers in Britain's major public utilities was lowest in Mrs. Thatcher's privatizations of the 1980s. Her Conservative Party advisors underpriced shares of British Telephone—and later those of the railroads and other companies formerly in the public domain—to give the customers of these firms a chance to benefit as capitalists-in-miniature, making quick first-day or first-week gains. But they lost out as prices were jacked up and service standards declined. Privatized bus companies sold off their centrally located terminals for their real estate value and cut back money-losing service. For the railroads, ticket prices soared, more trains crashed and passengers were jammed as London's real estate bubble of the 1980s and '90s forced people to live far away from their jobs in order to afford housing, which absorbed a rising share of their paychecks.

The policy was characterized as "Sorry you've lost your job. We hope you made enough money cashing out on your home or in the stock market to make up for it." The idea was for the victims of this process—the bottom 99%—to make enough one-time gains from carving up and inflating the economy to mute their opposition to the widening polarization between creditors and debtors, that is, between the financialized sector and the rest of the economy.

The stock market became an arena in the new financial warfare as it was turned into a vehicle for takeovers, mergers and acquisitions based on replacing equity with debt leveraging. Federal Reserve statistics show that more U.S. stocks have been retired since 1980 than issued. Despite the flurry of Initial Public Offerings (IPOs) during the high-tech dot.com bubble, the net flow of funds has been out of the stock market, not into it. The stocks that have been retired have been replaced with debt—"junk bonds," other bonds, mortgages and bank loans.

Credit to corporations is created to buy assets already in place or to ship goods and services already sold and waiting for payment, not to invest in new plant and equipment or employ labor to produce more. Meanwhile, corporate raiders and management buyout teams now purchase entire companies on credit. The post-1980 mushrooming of such credit was catalyzed by high-interest "junk" bonds, but as the Federal Reserve flooded the economy with credit, banks were able to ease loan standards and lower interest rates each year. Takeover credit became much more accessible. Raiders were able to obtain increasingly low-cost financing to buy out companies with returns on equity of 9 percent or more. The wealth of the population's richest 1% soared so rapidly as progressive taxes were slashed.

The logical culmination of this process is for the entire economy to be bought out by financial managers, or at least come under their control. The problem for society is that the aims of financiers are quite different from those that textbooks describe as being the aims of industrial entrepreneurs: namely, to invest in factories, plant and equipment and hire labor to apply new technology to produce more output at lower cost, creating the promised economy of abundance. Taking over companies with borrowed credit seeking to make quick gains on

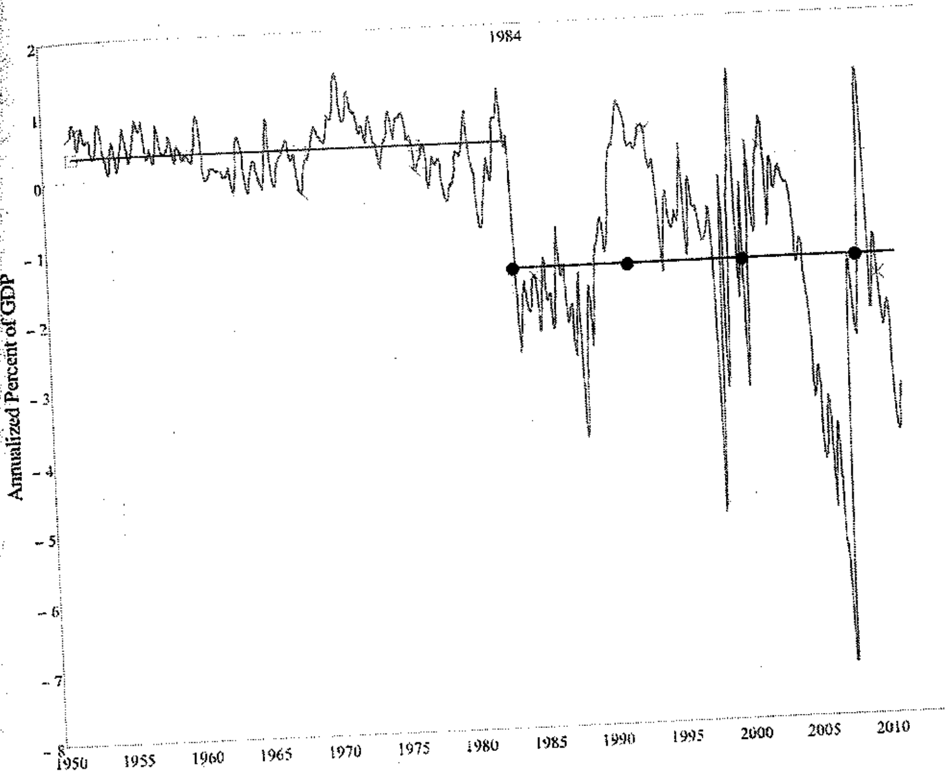

Fig. 1: Federal Reserve flow of funds: Net stock-market disinvestment, 1980–2010.

their stock prices—or to take the companies private, break them up, seize their pension funds, cut services, work-labor more intensively or outsource employment and downsize, and then to re-float the "streamlined" carcass—has become so pervasive that well-run companies fear being targeted. Their defense is to take "poison pills" by borrowing to buy up their own stock, making it more costly to raiders—while leaving themselves with less debt leeway for prospective raiders to capitalize into takeover loans. The idea is to use up their debt servicing capacity in advance, indebting themselves so heavily that no raider could hope to saddle them with enough more debt to pay for a takeover.

For most companies these days, buybacks create capital gains for stockholders—gains that are taxed at a much lower rate than dividend payouts. They also increase the value of the stock options that corporate managers give themselves—options whose value often exceeds their salary. But these debt-leveraged buyouts, buybacks and stock manipulation leave less revenue to invest in expanding business. So financial "gain-seeking becomes decoupled from tangible capital formation as managers spend earnings to push up the price of their stock by buybacks rather than by investing to generate more earnings.

Corporate Takeovers Replace Equity with Debt

Fiction: Bank loans and bond issues finance productive capital investment, creating profits that borrowers use to pay off their loans.

Reality: Banks extend most credit against property already in place. Most corporate bond issues since the 1980s have been to finance takeovers. This inflates asset prices, but does not finance tangible capital formation. Interest must be paid out of income streams already in place—or by cutting back capital spending and squeezing more out of employees or their pension funds.

The underlying fiction is that debt leveraging can "create wealth." What makes the indebting of industry so ironic is that it is being done via the stock market, which was founded to provide equity capital as an alternative to debt. This original role has now been reversed.

At first glance one might imagine that the 1992–2001 stock market boom might have led companies to take advantage of rising price/earnings ratios and replace bonds with stock. But the tax code favors debt financing rather than equity. Corporate dividends are paid out of after-tax profit, while interest is a pre-tax charge. At the 50 percent corporate income-tax rates still typical in the 1980s, companies could pay out twice as much in pretax interest as they could pay in after-tax dividends. The asymmetrical tax treatment has been a major incentive in turning the stock market into a vehicle for buying companies by loading them down with debt—at the tax collector's expense.

The pretense for making interest on bank loans and bonds tax-deductible is that it is considered to be a necessary cost of doing business. But takeovers are not part of the production and consumption economy. This market distortion prompts investors to shift away from equity financing to debt financing. As interest rates were receding from the 20 percent rate they reached in 1980, pension funds and other institutional investors sought higher rates of return—by lending to corporate raiders seeking to take over companies. Drexel Burnham took the lead in popularizing high-interest bonds. They were called "junk" because they increased the debt/equity ratio of companies far beyond traditional banking norms. So even as the stock market boomed with takeover offers, companies did not use this to reduce their debt overhead. Debt ratios soared.

Companies became more financially fragile. Stock dividends can be cut back when earnings decline, but interest must be paid regardless of how much the company earns. If a company cannot pay, it is declared insolvent and turned over to its creditors, wiping out stockholders. This became the fate of many companies skating on the increasingly thin financial ice—becoming more fragile because of tax favoritism for debt financing.

The reasons for this favoritism toward creditors is not technological, and did not spur capital investment. Banks, pension funds and other institutional investors lend to raiders and corporate empire-builders simply to buy up stock. The strategy of "financial engineering" is to make capital gains by downsizing and breaking up companies, or to bid up their stock prices rather than investing in more capital or hiring more employees.

Stock buybacks dispose of the surplus cash that acts like a red flag attracting raiders. Companies that operate in the old-fashioned way of building up capital investment and cash reserves find that their liquid assets and un-mortgaged property attract predators. So the spread of corporate debt becomes contagious, because it obliges companies to defend themselves by depleting their working capital and going so deeply into debt that few assets or earnings remain to be pledged to creditors.

The Adverse Effect of Debt-Financed Raids on Long-Term Corporate Investment

Fiction: Debt leveraging increases returns on equity as funds can be borrowed at a lower interest rate than companies expect to earn, enabling companies to pay off their debts.

Reality: Issuing high-interest "junk" bonds to buy out stockholders and "take companies private" raises the proportion of cash flow absorbed by interest, leaving less for new direct investment. So capital formation and employment slow, reducing economic growth.

The problem is that this kind of defense emulates the very policies that raiders threaten. Supporting a stock's price by buying it up or paying out more in dividends often involves dismantling a company's long-term investment plans and running up enormous debts. The company may make ends meet by cutting costs and employment drastically. This is what CBS did in 1987 when the "white knight" Larry Tisch fired employees and sold off $2.65 billion of CBS subsidiaries.

Tisch emerged from the new generation of corporate raiders who refined the practice of issuing bonds to buy out stockholders and their companies. In the spirit of the real estate principle that "rent is for paying interest," they organized takeover funds, arranged bank loans and issued bonds similar to mortgages. These were not productive debts to finance new capital investment. Rather than generating more profits, these new loans simply replaced equity.

Their interest charges had to be paid out of existing earnings—and by stripping assets.

All this was applauded by politicians on the right and left alike. In the spring of 1985, Senator Jesse Helms and other rightwing politicians backed Ted Turner's attempt to take over CBS. Their main objective was to change the station's liberal programming. Turner had founded the innovative Cable News Network (CNN), but lacked the resources to take over CBS. The only way he could do so was to offer $5 billion in high-interest bonds—the equivalent of $150 a share at a time when CBS stock was selling at a fraction of this price.

Wall Street was unimpressed. It thought he could deliver more right wing programming but not the dollars he promised. His basic business approach already had caused his Atlanta Braves baseball team to flop. Baseball players take years of professional training to reach the major leagues. Farm systems are run at a loss to provide this preparation, much like corporate R&D. Seeking to avoid such costly investment, Turner cut back on scouting ("research") and minor league development, and simply hired free-agent players from other teams. This meant selecting players past their prime and often injury-prone. The result was a money-losing last-place team. In 1990 he finally appointed a general manager who turned the team's fortunes around by developing one of baseball's best scouting and minor league systems. But this was after his CBS experience.

One of CBS's major stockholders was Larry Tisch, holding 5 percent of CBS stock. Soon after being elected to its board of directors, he announced his intention to save the company. Riding in like the proverbial white knight, he mobilized his family's holdings in Loews to buy 24.9 percent of its stock by September. This kept CBS in ostensibly friendly hands inasmuch as Tisch already was a board member.

Having made his money by diversifying his Loews theater chain into hotels and insurance, He was known for cutting payrolls and other costs. The first thing he did at CBS was to reduce its staff and begin negotiating to sell off assets, starting with its magazines for $650 million, and CBS Records to Sony for $2 billion. There were rumors that he might even sell the company's New York "Black Rock" headquarters and lease it back, raising cash but increasing the annual (tax deductible) rental outlay.

By the end of 1987 these policies had doubled Tisch's original $951 million investment in CBS. The company's total worth rose to about $7 billion and it was in a cash-rich position—a bonanza for its stockholders, the largest of whom was Tisch himself. But in the process of "saving" CBS he just what its officers and employees had feared Turner would do: sell off its properties and lay off workers. The white knight became almost indistinguishable from the raider.

Stock Buybacks to Increase Share Prices

Increasingly, corporate buybacks reflect management's desire to raise the stock price as an aim in itself, not merely to deter takeovers. In addition to serving the interests of shareholders in the short run, buybacks enable managers to exercise their stock options at a higher price. The drawback is that they divert revenue away from being invested to expand the company's long-term business.

During the 1990s, IBM routinely spent $10 billion of its earnings each year to buy its own stock. The company also borrowed. In effect, it was borrowing to bid up its stock price, not to expand research and development. In 1980, for instance, it contracted out its software technology for personal computers to Microsoft, and subsequently let other producers develop leadership positions for chips and associated hardware. Other companies did the same thing. By 2005 even staid General Electric announced in that it would sell its Swiss Reinsurance Company for $6.8 billion and use the proceeds to buy its own stock and raise its dividend payout.[1]

In 2004 the S&P 500 companies spent $197 billion on buying their own shares to support their price. The pace accelerated to over $100 billion a quarter by March, 2006, by which time these buybacks were running at a rate large enough to "cover this year's Medicare budget." Standard and Poor calculated that

> 268 of the companies in the S&P 500 bought back shares in the first quarter, with nearly 110 of them cutting their diluted shares outstanding by at least 4% from a year earlier. … Exxon Mobil Corp., Microsoft Corp. and Time Warner Inc. were the biggest buyers of their own shares during the first quarter, spending $14.37 billion combined, according to S&P.

As the *Wall Street Journal* report concluded:

> A company that aggressively buys its own shares on the market can give investors a skewed picture of its earnings growth. When a company reduces its shares outstanding, it will report higher earnings per share,

1 "Cash-Rich Firms Urged to Spend," Wall Street Journal, November 21, 2005. The article quotes hedge-fund manager Jeff Matthews as noting that "investors' demands for stock buybacks and the like are prompting some companies to do the wrong thing. . . . hedge-fund managers like himself are paid based on their portfolios' annual performance. So they tend to be short-sighted when they see a company with lots of cash and a languishing share price. 'I don't think it has as much to do with what's in the long-term interest of the company as in the long-term interest of the hedge funds,' he says."

even if its total earnings don't grow by a penny, simply because those profits are spread across fewer shares. Exxon Mobil's net income rose 6.9% in the first quarter, but that turned into a 12.3% earnings-per-share increase after share buybacks, according to S&P.[2]

Paying Greenmail to Deter Financial Raids

Raiders may negotiate "greenmail" payments to end their takeover threat. The target company agrees to buy the raider's stock at a price that gives him a nice profit on top what became a customary 0.375 percent (3/8 of a percent) commitment fee to the go-go investors who backed the greenmailer, the banking house that committed itself to underwrite the takeover, and the legal costs incurred in the cross-suits between the prospective raider's company and its target.

The attempted takeover of Phillips Petroleum by T. Boone Pickens and Carl Icahn illustrates the standard ploy. Icahn produced a financial plan to sell off $3.7 billion of Phillips' assets to pay for the takeover, leaving Phillips with about $11 billion in debt compared to only $800 million in common stock. This would have produced nearly a 14:1 debt/equity ratio, compared to the average 1:1 ratio for the oil industry as a whole. Debt-servicing charges would have added to Phillips' production costs, making it less competitive within the oil industry—and too cash-poor to sustain the exploration and development needed for long-term growth.

This is why Phillips and other companies fought hard against such raids. They did not want to dismantle their production and investment position simply to let bondholders strip their assets and income stream. So Phillips negotiated a settlement that left it independent, while Pickens made $90 million and Icahn over $50 million on the increased value of their stockholdings. Drexel Burnham Lambert got $1 million for letting Icahn use its name.

Biographies have been written about leading raiders such as Carl Icahn, T. Boone Pickens, Carl Lindner, Michael Milken and Ivan Boesky, Henry Kravis and their colleagues, along with stories about their takeover targets: Nabisco's $22 billion leveraged buyout, Beatrice Foods, Revlon, Goodrich,

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2 "Big Companies Put Record Sums Into Buybacks. Repurchases Aim to Bolster Shares but They Also Signal Hesitancy to Invest in Growth," The Wall Street Journal, June 12, 2006. Cisco Systems "approved the repurchase of an additional $5 billion of its own stock on top of a $35 billion repurchase plan it announced five years ago. The week before, Tribune Co. announced a $2 billion buyback, to be financed by debt, in a decision that sparked controversy on the company's board, with representatives of the Chandler family, one of the company's biggest shareholders, objecting to the massive outlay."

Weirton Steel and the various airline buyouts and bankruptcies.[3] Books could just as well have been written about companies that resisted takeovers by taking "poison pills" whose effects were nearly as bad as what the raiders would have done.

But personal and even corporate biographies run the risk of missing the forest for the trees. The junk-bond phenomenon is more than just an adventure story about some Wall Street raiders leveraging debt on a vaster scale than their real-estate counterparts. At stake is the fate of Americans who do not get rich from this financialization of industry. For instance, when the Leucadia takeover group bought out the National Intergroup conglomerate, no purchaser could be found for its Weirton Steel division. As a last resort Leucadia sold the plant to its employees. Rather than see it closed down, they cut their own wages and promised to pay for the steel plant with high-interest bonds. This turned the labor force into something akin to indentured servants working off the debts with which Leucadia saddled the plant.

This kind of debt-financed raiding increased the cost for Weirton to produce each ton of steel, and for Phillips to produce each barrel of oil. The additional unit cost may be computed by dividing debt service by physical output before and after the takeover attempt. On an economy-wide level, higher interest charges have become a major factor pricing U.S. goods out of world markets. So claims that leveraged buyouts and other debt pyramiding is part of the "free market" economy on its way to a Darwinian survival of the fittest refers only to asset markets and balance-sheet wealth (and indeed, wealth at the top of the economic pyramid, achieved by indebting the bottom 99%), not to "markets" leading to more competitive pricing.

Stock Market Strategies to Obtain Capital Gains Rather than Profits and Dividend Yields

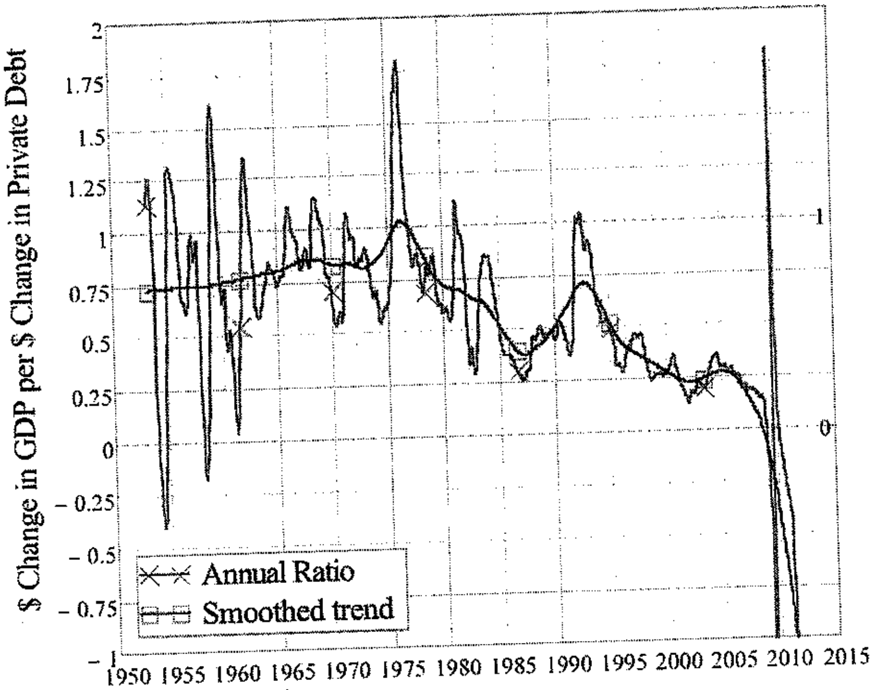
Fiction: Stocks are worth more because earnings are growing.

Reality: Stock prices reflect the flow of funds steered into (or out of) the market by tax laws, pension and retirement funding, and Federal Reserve credit bubbling to lower interest rates and hence raise the "capitalization rate" of a given after-tax revenue stream.

Financial bubbles inflate stock market prices for reasons that have little to do with "real" wealth creation. By pushing down interest rates after 1981, for

[3] For the $22 billion Nabisco takeover as the high point of excess from the 1980s see Bryan Burrough and John Hellyar, Barbarians at the Gate (1990). Drexel-Burnham's escapades and the prosecution that bankrupted Drexel and sent Michael Milken and Ivan Boesky to jail insider dealing are highlighted in Connie Bruck's The Predator's Ball (1988).

example, the Federal Reserve increased the "capitalization rate" of existing income streams. Borrowing terms became easier. But while debt-leveraged capital gains the market price of companies (and real estate) raised balance sheet net worth, this is done at the expense of earnings. Higher interest charges were built into a company's break-even costs. So what rose was not net income or tangible wealth, but the ratio of stock prices to earnings—and of course, the value of stock options given to upper management.



Source: Flow of Funds Table L1; BEA

Fig. 2: Falling rate of GDP growth per increase in debt

Until the 1980s, making capital gains on stocks tended not to involve actually taking over a company. Brokerage houses and investors looked for companies with undervalued assets, especially real estate bought long ago when prices were lower. Many auto supply stores, dairy distribution companies and other small companies had storage operations or retail outlets in neighborhoods where property prices were soaring. These companies also tended to have stable but not rapidly growing sales, which the stock market capitalized at low price/earnings ratios. Outside buyers could take over such companies, close them down and turn a $10 million sales-distribution business into a $20 million real estate deal by selling the property to developers. Or, a brokerage firm could buy the stock, provide its analysis to clients and watch them bid up the price—and then sell its holdings to make a trading profit.

Rising share prices in the stock market do not provide much benefit for the companies that initially issued them, unless firms issue new equity as well. By the 1960s the most noteworthy stock-market action consisted of corporate mergers. Aggressive conglomerates would offer to buy companies at a price higher than their stock was trading for. A 25 percent premium usually was sufficient inducement for shareholders to accept the offer. So if a company's stock was trading at $20 a share, an ambitious buyer might offer $25 a share. Brokerage firms and their clients pored over balance sheets looking for prospective takeover targets.

Growth companies with high price/earnings ratios sought to merge with slower growing firms by exchanging their high-priced stock for the relatively low-priced stock of these firms. This is what AOL did when it merged with Time Warner. Although Ted Turner's company had much larger assets and earnings, the stock market valued these at a lower price/earnings ratio, enabling AOL to swallow it much like a crocodile biting off a prey much larger than itself. The hope was that the newly merged company's stock price would enjoy a high price/earnings ratio. But the plan backfired as the bloom evaporated from AOL. The stock plunged to near the old Time Warner price/earnings ratio, making it one of the worst merger deals in history.

Apart from undervalued real estate, dominant market positions and intellectual property rights, the main bait for mergers was cash on hand—bank accounts, well funded pension plans, and low debt ratios. A new breed of financial manager accumulated cash simply by paying bills more slowly, and cutting costs by squeezing out more work—holding output steady in the face of attrition for the work force, and outsourcing employment to non-union labor. All this was considered to be the essence of sophisticated management practice.

Unprecedented amounts of credit became available to finance corporate buyouts. Instead of merely doubling one's money by buying a company for $10 million in one's own cash and selling it for $20 million, a ten-fold return—1,000 percent—could be made by borrowing $9 million of the purchase price, turning a debt-leveraged $1 million equity investment into a $10 million capital gain. The ideal was not to put in any of one's own money at all, but to finance the takeover entirely on credit. The return on this zero equity (that is, 100 percent debt pyramiding) was mathematically infinite. Going into debt became the way to get a free lunch. But it was not free for the companies being taken over, or for their employees or for the economy at large.

A new class of corporate raiders emerged in the 1980s. Their idea was to buy a company and cut costs—but not by raising productivity through capital investment and new technology. It was more like new landlords bleeding a hitherto well-maintained building and cutting the staff (or shifting to non-unionized labor), while increasing earnings by raising prices (much like raising rents). Corporate raiders looked for bankers to put up the money, just as real estate developers had long done. The bankers for their part saw these ambitious individuals as providing a major new growth market for loans. What made this harmony of interests work was the free ride that the government provided by letting corporations deduct interest payments from their reported income. The tax subsidy promoted the practice of loading industry down with debt, with the consequence that firms pay about twice as much of their income as interest as they could pay in after-tax dividends.

What made "junk" bonds—and mergers and acquisition in general—risky for the economy at large was that their proceeds were not used to increase productivity or overall earning power. The funding simply was used to bid up stock prices. At best, the strategy was to buy a company, "streamline" its management, run it more "efficiently" in the short run to squeeze out more earnings. Raiders might take a company private—that is, off the stock market—and turn it into a privately owned company, streamlining it and often selling off the parts at a capital gain. The aim was to cash out by selling the company back on the stock market.

At first, target companies tried to protect themselves by bringing RICO claims against raiders—a law initially designed to prosecute the Mafia. But the higher courts ruled that what raiders and their junk-bond backers were doing was legal. The trials of Michael Milken and his client Ivan Boesky did not focus on corporate raiding and indebting as such, but on the insider dealing that was the key to the takeover deals negotiated by Drexel Burnham Lambert. Before making a takeover announcement, the perpetrators would buy stock options for the companies they targeted. Options could be bought at a low price, and on credit. Suppose a raider planned to offer $30 a share for a company whose stock was selling at only $20. For perhaps only $1 he could buy an option to buy the shares at $20—and then watch his offer drive them up toward $30.

The legal problem was that under Franklin Roosevelt's New Deal reforms that followed the stock market crash of 1929, prospective buyers are legally required to give markets "full knowledge." This transparency principle is the premise on which free-market economics is supposed to work. Milken's "Drexel gang" violated it.

The Economy-Wide Effect of Financializing Industry

Some prominent financial leaders arrayed themselves against raiders loading industry down with junk bonds and depleting capital reserves via stock buybacks. Henry Kaufman resigned from the Salomon Brothers board of directors (and later from the firm itself) to protest its underwriting of debt-for-equity swaps. Felix Rohatyn of Lazard Frères also warned of the risk of burdening balance sheets with high interest obligations. The corporate lawyer Martin Lipton wrote a public letter to Senator Proxmire defending companies against raiders:

> These takeovers move assets into hands that profit by cutting off … research and development and capital improvements and instead divert those revenues to paying the debt incurred to acquire the assets. One can analogize the situation to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by planting cover and creating wind breaks. In the early years he will maximize his return from the land. It is a very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster. … Day after day the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing businesses to forego.[4]

Takeovers raid the social functions of capital, not just the company (whose shareholders may make a nice capital gain by selling their stock to raiders). These social costs do not show up on corporate balance sheets. Economists call them "external diseconomies"—consequences borne by society at large, as when debt-financed speculation leaves companies too cash-strapped to undertake new productivity-raising investment. Projects with long lead times are the first to be cut back, because they making companies ripe for takeover by a raider coming in to increase short-term earnings by reducing R&D and bleeding the company much in the way that landlords improve their cash flow by failing to keep up their rental properties.

Communities suffer when jobs are lost as raiders improve short-term earnings by cutting back on employment. Workers who formerly paid taxes now collect unemployment insurance. Meanwhile, the shift to pay interest rather than paying out earnings as dividends aggravates the federal budget deficit, creating pressure to increase taxes on the economy's non-financial sectors. The past thirty years' experience with junk bonds and corporate raiding, seeking the

[4] *American Lawyer*, May 1986.

best short-term management to raise stock prices—on credit—has burdened industry and the economy at large with financial overhead charges. Yet the economics profession followed bank lobbyists in advising that economies perform best over the long run by living in the short run, moving from one short-term spurt to the next. "Liquidity" Is the preferred euphemism for interest-bearing credit.

Typical of the applause for debt leveraging was President Ronald Reagan's 1985 *Economic Report of the President*. Noting that "contests for corporate control are part of a larger merger and acquisition process that plays an important role in the economy's adjustment to changing market circumstances," it endorsed debt-financed buyouts on the ground that whatever generates the highest return is the most efficient use of resources, concluding that "there is no economic basis for regulations that would further restrict the ... process."

This ideology of financial deregulation has promoted the junk bonding of industry, and ultimately a crash as the economy has been de-industrialized. Living in the short run, financial operators jumping from one company to another, loading each one down with debt in order to increase returns on equity. And this has been applauded. By 2006 the *Financial Times* wrote that: "With pressure on institutional investors to deliver short-term gains, corporate hell-raisers—once vilified as 'vultures' and 'speculators'—have become champions of better governance."[5]

"Creating wealth" by debt pyramiding is encouraged by the tax system's failure to distinguish between productive investment and speculation. Capital gains obtained by raiding a company or manipulating its stock are taxed at only half the rate as income earned by building a factory to increase output and jobs. And adding insult to injury, debt leveraging is subsidized by making interest payments tax deductible—aggravating the fiscal squeeze.

Nothing about this debt subsidy is a natural or inherent in markets. As Keynes pointed out in the 1930s, capital markets function best when governments adjust the rules to serve longer-term growth objectives. An obvious first step toward improving industry would be a tax structure that favors equity capital rather than debt, and holding stocks on a longer-term basis.

The Inevitability of Debt Default

Already before the bankruptcy of high-risk S&Ls in the 1980s, observers warned about the bankruptcy danger for companies whose earnings could not cover their high interest charges, and those that had indebted

[5] "Raiders rolling back the years," *Financial Times*, August 16, 2006.

themselves with poison pills to defend against financial takeovers. Securities and Exchange Commission Chairman John Shad warned that "even a mild recession" might force some companies into default on their junk bonds. "The more leveraged takeovers and buyouts today," he concluded, "the more bankruptcies tomorrow,"[6] leaving lawyers and accountants to carve up the hapless target companies to pay their creditors.

But the SEC has little authority to overrule the issue of junk bonds. It was not designed to protect the economy by setting rules for financing or taxing to promote long-term investment and financial viability. Its role is only to protect stockholders by pressing for full financial disclosure and other technical market functions such as limiting insider dealing and collecting accurate statistics for stock and bond investors.

Deposit insurance agencies—the FDIC and the Federal Savings and Loan Insurance Corp. (FSLIC)—likewise were unable to block junk-bond investments by banks and S&Ls. Defaults soon led to insolvency for savings institutions that held such bonds. Columbia S&L in Beverly Hills had nearly half (some $2 billion) of its depositors' funds in junk bonds. Its insolvency helped empty out FSLIC, which had permitted S&Ls to deviate far from their original purpose of financing homebuilding. The low price of Columbia's stock already by 1986 reflected the view of most investors that the S&L had jeopardized its long-term solvency by seeking high yields. Financial deregulation let these institutions invest in junk bonds for no better reason than to pay depositors a few percentage points more for a temporary period of time—at the cost of ending up losing their principal. The process occurred quite rapidly.

The financial problem is symbiotic with today's fiscal policy of taxing business earnings higher than capital gains on stock and bond speculation. This pro-financial tax philosophy is the diametric opposite of what classical economists advocated. It steers savings and new credit creation into loans, building up debt. By encouraging debt-leveraged buyouts, the tax-deductibility of interest has turned securities markets into vehicles for pension funds and other institutional traders to find the quickest returns by acting as short-term speculators rather than long-term investors.

Diverting Stock-Market Gains from Companies to Investment Bankers

Silicon Valley's dot.com and Internet leaders became multi-millionaires and sometimes even billionaires when their companies were floated on the stock market in the 1990s. They have become poster boys for the claim that

[6] Wall Street Journal, December 12, 1987.

Wall Street rewards innovation. Yet they received only a portion of the money raised by the Initial Public Offerings (IPOs) of stocks in their companies on the day they went public and over the next few trading days. Their venture capitalists took the lion's share as sleeping partners, along with the investment bankers who marketed these stocks.

First-day price jumps of 100 to 400 percent were normal for IPOs in the information sector, sometimes more than seven-fold. The higher the jump, the more successful the flotation was deemed to be—successful in attracting investment bank clients to the next underwriting. The earliest buyers got the quickest and largest gains. The companies got only the initial offering price—less underwriting commissions typically 7 percent—higher than the 6 percent commission charged by real estate brokers. In addition to this rake-off, the bankers who underwrote these offerings got much of the price run-up for their own trading account.

These gains made the interest of Wall Street inherently opposed to that of companies going public, which received far less than their stock proved to be worth after only a few hours of trading. Many small buyers who jumped onto the bandwagon lost their shirts after the bubble burst in 2001. The process is best described in the prosecutions mounted in 2002–04 by New York State Attorney General Eliot Spitzer, who fined Wall Street's leading firms over $1.5 billion for engineering price jumps in an illegal way. Still, their gains far outweighed the penalties negotiated with law enforcement agencies.

The felony case against Frank P. Quattrone is illustrative. Employed as a stock analyst by Credit Suisse First Boston to tout high-tech shares, he was convicted on May 3, 2004, for destroying evidence in the government's investigation of his firm's wrongdoing. Prosecutors showed that what passed for research was a con job, for which his firm paid a fine of $100 million—without admitting criminal wrongdoing (thus avoiding a raft of civil lawsuits by its victims).

The Linux flotation provides an object lesson for the kind of insider dealing that became rife. When Credit Suisse brought the company (then called VA Linux) public in December 1999, it pretended that Linux's prospective earning power justified an initial offering price of $30. But by the end of first day the stock had changed hands numerous times as it soared to $320. It then fell back to close at $239.25, more than seven and a half times what it had sold for in the morning. This price exceeded what Linux would be selling for by the end of 1999—still remarkably high, considering that its shares would plunge to just 54 cents by 2002 and then would settle in the $2 range, about 1 percent of the first day's peak price.

Who benefited the most? At the head of the pack were the underwriters, followed by the favored pension funds and other institutions who got first crack at the shares and flipped them to new buyers by mid-day. Then came the venture capitalists that helped fund Linux. In the final position were the "content providers" who actually created the company's technology. They didn't receive anything like the $239 their stock ended up selling for in the first day. They didn't even get all that much of the $30 a share at which the stock was issued, after Credit Suisse First Boston took its commission and the venture capitalists got their share.

The venture capitalist's role is to find innovative individuals and start up a company for about $10 million, retaining control over how it is spent. They draw up a partnership agreement replete with small print spelling out how many shares of common and preferred stock they will get, and what proportion of the money they will receive when the company goes public — with management fees for themselves (usually about 2.5 per cent). As one reporter has described,

> preferred equity gains leverage when a company is sold for close to its original valuation, or a small multiple. The funding deal can be structured so that a venture capital fund with 20 per cent preferred equity stake takes up to 40 per cent of the sale proceeds, plus a dividend, and "double dips" by claiming 40 per cent of the remaining capital gain. A technology entrepreneur who has a 30 per cent equity stake may end up with less than 5 per cent of the proceeds.[7]

The bulk of the money raised accrues to the venture capital partners and their investment bankers. Retail investors are shut out of the most lucrative action. To protect their interest and stop "crony finance-capitalism," Congress passed the Oxley-Sarbanes Act in 2002. The idea was to put all customers on the same footing. It was a good idea as far as it went, but its reforms and those that followed Mr. Spitzer's prosecutions were mainly administrative. A more structural solution was needed to refocus stock ownership on the longer term rather than quick in-and-out trading.

One reform under discussion is to require initial buyers (including institutional investors) to hold stock for a reasonable period of time, at least a month. This is still short-term as capital markets go. Another suggestion is a stock-transfer "Tobin" tax. This would absorb a high margin of speculative gains traded on highly debt-leveraged terms. The average high-tech stock trades so rapidly that it now is normal for an amount equal to a company's entire stock

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[7] John Gapper, "Google's auction exposes intermediaries' phoney war," Financial Times, May 5, 2004.

issue to turn over every day. This increasingly frenetic stock trading is Wall Street's most profitable activity. And most of this trading is on credit, enabling banks to charge interest on financing this speculation. Now supplemented increasingly by complex computerized derivatives, it is gambling on probability curves, decoupled from tangible capital investment.

Google Attempts to Avoid Short-Term Financial Constraints

Realizing that it would take a long time for more far-reaching reforms to be enacted, the Internet search company Google sidestepped at least the most obvious traps. It began preparations in 1999 when it sold 10-percent partnerships to Sequoia Capital and Kleiner Perkins Caufield & Byers for $12.5 million each. The holdings of these two venture capital firms ended up being valued at about $40 billion, for a 1,600-fold return on their investment. As for the investment bankers, Google limited their commission to just 3 percent, less than half the usual 7 percent rake-off. And to avoid the usual rapacious underpricing of its shares, it hired Morgan Stanley and Credit Suisse First Boston to hold a "Dutch auction." Prospective buyers were invited to submit their bids, and a price would be set to clear the market. The idea was to exclude speculators by giving all buyers an equal opportunity to buy shares at the moment of issue.

Google's founders Larry Page and Sergey Brin spelled out their critique of this process in a letter they included with the "Owners Manual" for their stock offering in 2004. Contrary to Wall Street tradition, they explained that they would not make quarterly earnings estimates, because their focus was on the long run rather than the short term:

> In our opinion, outside pressures too often tempt companies to sacrifice long-term opportunities to meet quarterly market expectations. Sometimes this pressure has caused companies to manipulate financial results in order to "make their quarter." In Warren Buffett's words, "We won't 'smooth' quarterly or annual results: If earnings figures are lumpy when they reach headquarters, they will be lumpy when they reach you."

To make sure that stock market investors would not have an opportunity to oppose this strategy, publicly traded shares would have only a tenth of the voting power of those kept by the company's founders. As they explained:

> If opportunities arise that might cause us to sacrifice short-term results but are in the best long-term interest of our shareholders, we will take those opportunities. …

> Although we may discuss long-term trends in our business, we do not plan to give earnings guidance in the traditional sense. We are not able to predict our business within a narrow range for each quarter. We recognize that our duty is to advance our shareholders' interests, and we believe that artificially creating short-term target numbers serves our shareholders poorly. We would prefer not to be asked to make such predictions, and if asked we will respectfully decline. A management team distracted by a series of short-term targets is as pointless as a dieter stepping on a scale every half hour. …
>
> We will not shy away from high-risk, high-reward projects because of short-term earnings pressure.[8]

Logical as this approach seemed to be, Wall Street did not approve. "Let's hope this doesn't become a precedent," one banker remarked. A hedge fund manager told the *New York Times* that he thought

> shareholders should punish Google for its failure to give new investors the same rights as its founders. Once a company goes public, its founders must understand and accept that they are responsible to public shareholders and are no longer fully in control.[9]

This was the mentality that Google sought to avoid. Its stock was issued at a price of $100 by Dutch auction on August 19, 2004, and then doubled by October and tripled by the following June—just what the company also had tried to avoid. But at least the price run-up seemed motivated by a better understanding of the company's long-term earning power, not by the kind of insider deals to favored customers that had inspired Google to avoid the typical Wall Street ways.

Underwriting Rip-Offs to Deprive the Public and Private Sectors of Realistic Asset Value

Google learned what to avoid by watching how underwriters handled most stock issues. The most egregious examples occurred outside of the United States, above all for privatizations of public enterprises. Shares in these companies were underpriced as a political ploy to promote privatization, starting

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8 "Excerpts from 'Owner's Manual' Included With Offering," *The New York Times*, April 30, 2004.

9 "Google Says To Investors: Don't Think of Flipping," and "An Egalitarian Auction? Bankers Are Not Amused," *The New York Times*, April 30, 2004. See also Frank Norris, "Google May Have Pre-empted Regulators on Public Offerings," *The New York Times*, May 4, 2004.

with British Telephone in 1982. The guiding idea of Mrs. Thatcher's Conservative Party was to make these stock issues a "steal" for employees and customers of these firms, as well as for investors in general to make quick windfall gains.

For starters, British stock underwriters received a quite unnecessary windfall. The government made no attempt to negotiate lower issue fees than the 7 percent monopoly rate that underwriters were used to charging small and untested companies for new issues without clear earnings prospects. The public enterprises being sold off already had an established earnings stream, so little research was needed. Two percent or at most 3 percent would have been enough to obtain the underwriting services needed to sell the stock, given the enormous size of the issue. But providing a free lunch at public expense became the essence of the new finance capitalism.

The post-1980 rise of finance capital can be attributed in large part to its ability to privatization of public and private-sector capital on credit. Britain's government could have received five or six times as much as it did by offering only about 20 percent of British Telephone initially in order to establish a logical—and much higher—market price, and then selling the balance of the company. Instead, it underpriced the entire company's value to stock market investors and underwriters. The magnitude of this and similar giveaways is so large as to be transformative, because the largest capital investment in most economies prior to the financial conquest of the 1980s was infrastructure in the public domain. By focusing on "capital formation" as being a private-sector phenomenon, economics textbooks—and financial "free market" lobbyists—distract attention from the privatization giveaways that have been a major factor in enabling the economy's wealthiest 1% to sharply increase their share of wealth and income.

The process was capped by the privatized infrastructure monopolies to raise access prices ("rent extraction") and transform industrial economies into rentier tollbooth economies. This transformation was achieved in part by the financial sector using its rich takings to mount an attack on government price regulation (making the spurious claim that "free markets" were ones that permit monopoly gouging), untaxing property rents and capital gains (on the claim that "free markets" needed a flat tax falling on labor, not on finance or real estate), and using the power of advertising and subsidy to drown out the concept of free markets that had been developing in the last few centuries of Western civilization. This was the essence of Thatcherism. And in America Ronald Reagan's team applauded it as the wave of the future. The barbarians were at the gates.

One might expect that this experience would dissuade underwriters from claiming that they give investors and corporate clients a fair idea of the value and prospective dividend stream for the shares being issued. But privatization stocks were not priced to take into account the fact that earnings would rise as private management was freed from the behavioral constraints that public companies had to follow. Yet it was precisely to break "free" of such regulation that public companies were being privatized by the Thatcherites! So it was mainly investment bankers and underwriters, stockbrokers and money managers that made money from their rake-off fees, administrative overhead charges and short-term trading gains. These financial operators depict themselves as key intermediaries mobilizing peoples' hard-earned savings to fund innovations that propel the economy forward. Yet what Wall Street and the City of London has been selling is debt leveraging, downsizing and outsourcing, privatization and de-unionization—culminating in austerity planning and what is best characterized as a race to the bottom. The economy shrinks, and many small savers are left holding an empty bag with a mountain of debt attached to it. It was not how economic futurists a century ago expected the era of progress and abundance to develop.

The main talent that underwriters and money managers really need to succeed is greed, and this is something that cannot be taught in school. Its spirit is extractive and parasitic, not productive. Its route to success is not to make profit in the classical way, by capital investment to produce goods and services. Bankers and financial managers prefer the easier route of making money by transferring property into their own hands, and "extracting rent" by siphoning off real estate and stock market gains fueled by debt-leveraged asset-price inflation, and monopoly rents from key technologies such as Microsoft or "intellectual property" such as Walt Disney.

Some Almost-Successful Takeover Attempts of 2005

Fiction: Corporate takeovers streamline inefficient management by cutting the fat.

Reality: Financial predators cut bone and muscle as they reduce investment programs with long lead-times. They increase returns by paying bills more slowly and running companies deeper into debt—to raise stock prices, not production.

Companies traditionally increased their dividends by investing in tangible capital to earn more profits, or cutting costs and/or raising prices for their products. But by 2005 an aggressive new source of financing developed. The idea was to mortgage corporate real estate and pay out the loan proceeds as dividends. This promised to make money in a purely financial way, by stripping assets to increase stock prices. Rather than investing in new capital to expand the business, raiders aim is to acquire assets already in place and sell them for a price gain, or even borrow against them to bid up stock prices. Earnings would be fully paid out instead of being invested in tangible capital formation. Financial managers would take the money and run, leaving indebted corporate shells in place of solvent companies.

Raiders (now euphemized as "activist shareholders") need buy only 5 or 6 percent of a company's stock or round up hedge funds and other speculators in order to mount a proxy fight and pressure companies to raise dividend payouts and share buybacks. Their tactic is to pledge corporate assets for debt service, using the stock market as a vehicle to replace equity with debt. Whatever assets were not already collateralized, especially cash or pension funds, became a red flag similar to the curse that plagues countries with rich oil deposits—a target tempting predators to buy a company's stock on credit. *Financial Times* columnist John Gapper described how dangerous sizeable corporate cash holdings could be:

> Companies have made themselves vulnerable to activist hedge funds by playing safe in the past three years. After the scare of the collapses of Enron and WorldCom, they paid down debt and amassed cash in case they suffered a similar crisis. Now, according to Standard & Poor's, US companies hold $ 1,300bn of cash and liquid assets—more than 10 per cent of all balance sheet assets.[10]

Next to liquid cash assets, corporate raiders concentrated on real estate. Among the hottest targets are food chain stores with property in prime locations that accounted for a high proportion of their net worth. Hedge funds take short-term loans to buy land-rich companies, and repay this bridge financing by mortgaging the property. Retail stores in particular own prime real estate locations, especially the large British grocery chains—and in the United States, the major restaurant chains.

Liquidating Corporate Assets

Fiction: The stock market raises long-term equity capital as an alternative to debt.

Reality: The stock market is becoming a vehicle for corporate raiders to untrack long-term investment planning by indebting companies to the hilt, cashing out, and running.

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[10] John Gapper, "Hedge fund agitators deserve to be heard," *Financial Times*, November 17, 2005.

Hedge fund managers pressed predatory finance to new limits in November 2005. Carl Icahn, one of the most notorious raiders from the 1980s, bought over 3 percent of Time Warner stock, and other hedge funds controlling a similar amount joined him to stage the largest proxy fight in U.S. corporate history. Lazard also set a precedent by acting as his advisor—the first time a staid Wall Street investment bank joined in attacking a blue-chip company, its traditional client base. Its 343-page report by Bruce Wasserstein urging Time Warner to bid up its stock price by raising its annual buybacks from $5 billion to $20 billion. He also suggested that the company break itself into four parts and sell them off to pay quick dividends to stockholders.

Around the same time, William Ackman's Pershing Square Capital hedge fund bought options on 4.9 percent of McDonald's. McDonald's was land-rich, owning more than a third of the land underneath its 13,500 restaurants in the United States and 30,000 worldwide. This un-mortgaged property was bankable, providing a borrowing opportunity that made the company a takeover target in the closing months of 2005. Mr. Ackman rounded up Vornado Realty Trust to buy another 1.2 percent, and a few other funds joined in to mount a proxy contest for control of the company. Among them was Whitney Tilson's hedge fund T2 Partners. Tilson, earlier had urged Wal-Mart to buy back its stock and "take advantage of the low interest-rate environment and take on debt, allowing it to both expand and buy back shares."[11] The raiders thus shared a similar mentality and game plan.

This was the second fast-food company that Mr. Ackman had attacked. Earlier he had cornered 9.3 percent of Wendy's stock, enough to force it to spin off its Horton's coffee-shop division and pay out the proceeds as dividends. His plan for McDonalds was even bolder: The company would sell two-thirds of its restaurants for $3.3 billion, and raise $9 to $15 billion more by mortgaging its real estate to the hilt, using the proceeds to buy back its shares. It would spin off its wholly owned restaurants into a distinct property company (McOpCo), which would lease them back to McDonald's, while selling 20 percent of its shares to raise a further $1.3 billion.

Mr. Ackman forecast that these policies would enable McDonald's to triple its dividend from 67 cents to $2 per share, raising its stock price by about 10 percent (around $2 to $4 per share), despite the fact that it would reduce the company's net worth by paying out the value of its assets.[12] For Mr. Ackman's plan to work, buyers of McDonald's shares would focus on its short-term dividend yield, not on the company's long-run prospects as it became more financially fragile.

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11 "Cash-Rich Firms Urged to Spend," Wall Street Journal, November 21, 2005.

12 "Investor urges McDonald's to sell off restaurants," Financial Times, November 14, 2005.

McDonald's officers explained that the plan would discourage prospective new franchise purchasers, who naturally would fear that the proposed real-estate affiliate would charge high rents. That is what landlords tend to do, after all. So making money as a landlord would reduce the viability of the fast-food operation. And on purely financial grounds the debt leverage proposal would strip the company's assets and leave it deeply indebted. Chief financial officer Matthew Paull characterized Mr. Ackman's plan as "financial engineering."[13] But as the *Wall Street Journal* observed: "In the hedge-fund world, 'financial engineering' isn't a pejorative."

It was not as if McDonald's needed rescuing. Since 2002 it had raised its dividends by 185 percent, tripling its share price at a time when most stock market averages were drifting downward. In any event, none of the hedge-fund proposals involved restaurant management as such. Their aim was pure asset stripping—borrowing against property not yet pledged as collateral, and paying out the loan proceeds to shareholders to produce a price jump—brief, but sufficient to enable the hedge funds to dump their shares for a quick killing.

The tragic consequence, for the economy at large as well as the companies being raided, is that after the financial dust had settled, the company would be left deep in debt. As the above-cited *Wall Street Journal* report summed up the threat: "Even the very best management teams aren't safe in today's free-for-all corporate environment." In the new financial perspective, "Holding so much [cash] is inefficient: companies reduce their return on equity by having too little debt. That makes the smaller ones targets for private equity funds."

As matters turned out by February 2006, Mr. Icahn and Mr. Ackman failed in their takeover attempts. Mr. Ackman did succeed in debt-leveraging his hedge fund's holdings of McDonald shares, and cleaned up when the stock jumped by 11 percent by January 2006. But at least McDonald's remained in one piece. So did Time Warner, where Mr. Icahn was unable to convince most shareholders that he could significantly improve its stock performance. Its shares remained stuck around $ 18, far from the $ 26 level he claimed his policies would produce. Lazard, which had negotiated a fee of $ 5 million for every $ 1 increase in Time Warner's share price, also lost.[14] Still, the attack forced the company to quadruple its share buybacks from $5 billion to $20 billion annually, and slash operating expenses by $ 1 billion. This prompted Fitch Ratings to downgrade the company's bonds a notch, from BBB+ to BBB.

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13 Alan Murray, "Attack on McDonald's Heralds a New Order," *Wall Street Journal*, November 23, 2005.

14 "Icahn Plan For a Split Gets a Push," *The New York Times*, February 8, 2006.

Taken together, these two episodes show how little today's post-modern hit-and-run finance has to do with actual capital formation. It turns upside-down the original idea of creating joint-stock corporations. They were expected to transform financial organization by creating large companies that would finance their expansion by raising permanent funding in the form of equity capital rather than debt. The advantage of equity was supposed to be that companies could pay their backers out of profits. If they make losses or their profits fall, they can cut back dividends accordingly. So equity reduces the risk of bankruptcy, making shareholders partners with the active manager-owners. But if companies do not pay the scheduled interest charges owed to creditors, they come under creditor control and stockholders may be wiped out.

The short time frame of financial managers thus loses the advantage of long-term, flexible equity funding. Stock markets are subjecting companies to short-term management seeking gains by trading stocks and downsizing—that is, in ways that are largely decoupled from providing new financing for corporate investment. Today's financial management philosophy—reinforced by the tax code and deregulation of corporate oversight—calls for cutting back R&D, downsizing the labor force, raiding pension-fund reserves and degrading defined-benefit plans into defined-contribution schemes. These policies are imposing a debt overhead on industrial capitalism as finance capital takes over industry, real estate and monopolies.

Junk Statistics

Fiction: Corporate land has almost no market value.
Reality: Land accounts for most growth in corporate property value.

In view of real estate's importance in determining corporate net worth—and hence, borrowing power, as the McDonald's episode illustrates—one might expect Federal Reserve statistics on America's balance sheet to provide a fair valuation of corporate land. But its economists treat the market value of real estate as consisting mainly of buildings, not land sites. Starting with a market appraisal based on Census Department estimates for overall property prices, Fed statisticians then estimate the original cost of buildings and multiply this number by the Commerce Department's index of construction costs to calculate their replacement cost. Whatever statistical residual remains between this estimate and current market value is attributed to land. The pretense is that buildings gain value simply as a result of price inflation increasing their replacement costs. Yet their owners are depreciating them—claiming that they are "recouping their capital," even as their market price is being inflated by while inflation or easier credit, public infrastructure spending and general prosperity. These are not recognized as having any effect—presumably because it is harder to justify such "free lunch" gains for landowners. When they do sell their depreciated properties, they do not even have to pay low capital gains taxes if they reinvest their money in buying yet more property. So the tax system subsidizes a free-lunch *rentier* economy.

The seemingly empirical statistical nonsense that this methodology produces is illustrated by the fact that in some years this "land residual method" has left no land value at all! The Fed's replacement-cost index for buildings rose so far in excess of actual market prices that by 1994 it reported the market value for U.S. corporately owned land as being a *negative* $4 billion. The implication was that America's corporations, as a whole, would have been willing to pay anyone $4 billion just to take all the negatively valued land they owned off their hands. The land's apparently negligible statistical valuation was "crowded out" by the replacement-cost index.

When systematic on-going error is continued for generation after generation, there invariably is a special interest involved. In the case of land valuation, this interest goes back to the classical debates of the 18th and 19th centuries, above all the attempt by the Physiocrats, Adam Smith, John Stuart Mill, Henry George and the Progressive Era to tax land rent as society's major form of unearned income and wealth. The idea was that taxing land rent would save it from being pledged to the banks as interest, and thereby would keep down housing prices (which are set at however much banks will lend). A land tax also would free governments from having to burden labor and industrial capital, thereby keeping their supply price low (as taxes, like interest, raise the price of production via the cost of living and doing business).

But since World War I the *rentiers* have fought back to shift taxes off themselves onto labor, consumers and even industry. Empowered by the symbiosis between finance, insurance and real estate (FIRE), rent extractors have fought to keep their free lunch out of the hands of government precisely because it is free, and easy to obtain. As J. S. Mill explained, land rent and rising prices for land are a gain that landlords make "in their sleep." And since his day the democratization of property ownership on credit has enabled landlords to sell out—with banks providing the mortgage loans to buyers who bid against each other to see who will pay the largest proportion of the land rent to the banks in exchange for the loan to acquire the property. Not only homeowners do this, but corporations seeking to turn around and sell the land at a higher price.

If the Fed's estimates were realistic and corporate property value resides in its buildings, little gain could be made in tearing down properties to gentrify or rebuild. But prices for commercial and industrial sites have been soaring in prime locations such as New York's midtown, downtown Tribeca neighborhood and even the Lower East Side and darkest Brooklyn, as well as in Chicago's Loop and on the South Side's gentrified neighborhoods in which Barack Obama played so active a role on behalf of the Pritzker and Crown families. So the Fed's economists had enough good sense to be properly embarrassed by their unrealistic land valuations, and stopped breaking out corporate land value separately in their balance-sheet estimates since their 1994 report. This behavior of the Fed shows the degree to which seemingly empirical economic and financial data are still being subjected to ideological distortions lingering over from the 19th century's tax reform debate seeking to tax land rather than labor and manmade capital investment. It is testimony to the ability of rentier interests—indeed, the FIRE sector acting in concert—to conceal the degree to which wealth is not earned by labor or enterprise as modern popular morality holds should be the case.

The absurdity of the Fed's low land-price statistic is shown by the avidity with which speculators search for companies with undervalued or "under-mortgaged" land—sites that official statistics hold to be nearly worthless. The more reasonable procedure is that which inspired Mr. Ackman and other corporate raiders—to start with land prices and assign the residual value to buildings. If the Federal Reserve's balance-sheet statistics were realistic, stock market raiders would not be able to make quick gains in the way that Mr. Ackman's hedge fund tried to extract from them McDonald's—"capital gains" that actually reflect the property's growing site value that could be liquefied by mortgaging it.

"Like a Plague of Locusts": Stock Ownership without Responsibility

Fiction: The stock market sets share prices responsibly to reflect long-term growth prospects.

Reality: Companies are valued in terms of their short-run liquidation value.

Making money financially is not the same thing as earning income by industrial investment. Providing easy tax-deductible credit for corporate raiders and hedge funds has turned high finance into a hit-and-run game by making a company's breakup value more important than how much it can produce and earn over the longer term. It seems not to matter that companies are left highly indebted with little cushion against economic downturns. The bubble mentality views a liquidity cushion or unpledged net worth as a free asset not "making money."

For many years corporate raiders have looked for companies that carry assets at less than their current market value. Such companies can be bought at a discount and their real estate, licensing rights or other assets sold off for a capital gain. The government has subsidized such takeovers by lowering taxes on capital gains below those on earning profits, wages and salaries. This encourages financial speculation and the indebting of corporate industry rather than new capital investment.

Much of the problem could be cured by stopping the practice of permit-ting interest to be counted as a tax-deductible cost of doing business. This dis-tortion encourages raiding and "value extraction" by loading companies down with debt. What determines a firm's worth under today's conditions is how much it—or an outside bidder—can borrow against its liquidation value. In today's Orwellian financial vocabulary, "wealth creation" is based on asset stripping, not tangible capital formation. This prompted Franz Müntefering, former chairman of Germany's Social Democratic Party, to tell his fellow politicians at a conference in April 2005: "Some financial investors don't waste any thoughts on the people whose jobs they destroy." Hedge funds and buyout firms harmed the national interest by draining companies of their wealth and shrinking the economy's employment prospects. "They remain anonymous, have no face, fall like a plague of locusts over our companies, devour every-thing, then fly on to the next one."

Most money now is made not by making goods and services but by buying and selling assets, from real estate, stocks and bonds to entire companies, and using financial engineering to leverage this trading on credit. The financial sector describes wealth as increasing as long as asset prices rise. But the "wealth" in question consists of financial securities and claims, not the "real" production-and-consumption economy. It is created seemingly out of nothing—out of the financial system's ability to create debt and attach it to properties. This engineers higher asset prices by using debt to pyramid one's own minimal equity—freely created credit that has no cost of production.

Some companies are shunning the stock market altogether. When Koch Industries, for instance, reached an agreement to take Georgia Pacific private, the logic in avoiding the stock market was similar to that of Mr. Müntefering. As Georgia-Pacific's chairman and chief executive A.D. 'Pete' Correll explained, "private ownership will allow the company to make investments that might well have been eschewed by public shareholders." Whereas share-holder "activists" wanted the company to pay out its revenue instead of re-investing it, "Georgia-Pacific may now be able to put more money into its commodity building-supply businesses."[15]

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15 "Koch Industries Agrees to Buy Georgia-Pacific," The Wall Street Journal, November 14, 2005.

For hundreds of years, family firms have gone public to obtain capital needed to expand. But since 1980 this historical trend has been reversed. As ownership has diffused, it became divorced from day-to-day corporate management. Companies are retiring their stock and going private. They are using their earnings not to invest in expanding their scale of operations, but to buy up their own stock, either to support its market price (thus making it more expensive to potential raiders) or to retire it and leave the company the personal property of its new owner. Companies are stripping themselves down to retain only those divisions with the highest and shortest-term payouts.

The prosecution of Frank Quattrone showed that Wall Street earnings estimates were as little concerned with reality as were the junk mortgage packages in the lead-up to 2008 or the happy-face estimates of Greek sovereign debt before 2011. These examples should suffice to controvert the assumption that market efficiency is assured by "full knowledge."

Fiction: Bank loans finance productive capital investment, creating enough profit to enable borrowers to pay off their loans.

Reality: Banks extend most credit to buyers of property already in place, enabling corporate raiders and real estate speculators to pay interest as their loans inflate asset prices.

This price rise enables debtors to pay interest charges by taking out larger loans. But as bonds have been issued more to finance corporate takeovers than new capital investment since the 1980s, the effect has been to shrink the industrial economy's ability to carry the growing debt overhead.

Today's debt-driven financial system is both inflationary and deflationary. It is inflationary in a novel way: Credit produces capital gains by supplying easy, increasingly low-interest financing for borrowers to spend on bidding up property and stock market prices. Companies forego tangible investment in order to increase their share prices by paying higher dividends or buying back their stock. The media welcomed this asset-price inflation as constituting a new form of wealth creation—as long as asset prices rather than wages or consumer prices are being inflated. But credit is debt, and debt needs to be paid—absorbing income that otherwise would be spent on goods and services. The result is debt deflation.

The underlying problem, as Aristotle noted long ago, is that money as such is sterile. Brokers may advertise "Let your money work for you," but money doesn't really work. People work. Money seeks to obtain the surplus they produce. And when the creditor's gain is the debtor's loss, making money financially is a zero-sum game for the economy as a whole. "Making money from money" means using credit to leverage asset purchases in search of capital gains. The process has little linkage with increasing production or living standards. Labor may be worked more intensively to squeeze out enough revenue to carry the rising debt burden. But this is exploitation in a non-productive form. Employees are indebted more deeply, and a sense of desperation replaces the hoped-for leisure economy.

Part of finance capital's problem is its high liquidity, seemingly a virtue as compared to fixed industrial capital. Hitherto staid institutions are turning their portfolios over at a dizzying rate as they jump like fleas on and off of quick zigzags in stock market values. The hope is simply to outperform the Dow Jones Industrial Average (and other fund managers) on a monthly basis. The long-term position of companies whose stocks are being traded so frenetically is a secondary consideration, because stocks are sold before the long run ever arrives.

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Financializing Industry Abroad

Financial parasitism is becoming worldwide as the trend toward neoliberal (that is, pro-financial) ideology makes it more difficult for nations to regulate their financial markets and protect their industry from debt. The *Financial Times* recently reported:

> Private equity groups operating in Europe are loading the companies they buy with record levels of debt, new data show. In particular, the so-called 'leveraged ratio'—or the ratio of debt to core earnings—has risen sharply, suggesting that some companies could struggle to repay debt if their performance deteriorated suddenly. … One measure of this trend is the ratio between a company's debt and its core earnings—earnings before interest, tax, depreciation and amortization—seen in the debt markets. In March, companies raising finance that had a rating below investment grade had debt that was 5.73 times

ebitda, according to S&P's Leveraged Commentary Data. This is the highest figure since the leveraged loan market started to be tracked in Europe in the late 1990s."[16]

The phenomenon is global, not confined to the United States. The strategy of financialization is not only to appropriate the public domain via privatization, but to take companies traded on the stock exchange "private," that is, for individuals to form hedge funds to raise the funding to buy them out on credit. The British retailer Debenhams, for instance, was bought in this way. The new owners sold off its stores for cash, which they paid out to their backers, and then agreed to lease them back. "The enfeebled company was then sold back to the stock market. … This is not pro- but anti-wealth-creation. … private equity has been able to carry short-termism to new extremes. This is said to raise productivity and performance." However, Will Hutton argued: "The chief reason British business remains at the bottom of the international league tables for innovation, research and development, and productivity growth is because of too much takeover and too much private equity. Innovation lowers short-term profits."[17] This financial devouring of wealth is achieved by the ability of banking interests to lobby for a perverse set of tax incentives "that favour takeover [and] need to be removed." But both the Conservatives and Labour Parties have accepted the logic that debt-leveraged asset-price inflation is "wealth creation."

But credit is debt, and debt needs to be paid—absorbing income that otherwise would be spent on goods and services. The result is debt deflation.

Similar global pressure is at work in Japan. "Growing corporate terror of takeover is spurring companies to use excess cash to pay higher dividends. This cuts cash reserves, making companies less attractive as targets. It also

16 Gillian Tett, Louisa Mitchell and Peter Smith, "Private equity acquisitions loaded with debt," *Financial Times*: May 25, 2006. Ebitda is an acronym for earnings before interest, taxes, depreciation and amortization.

17 Will Hutton, "Private equity is casting a plutocratic shadow over British business," *The Guardian*, February 23, 2007.

pleases existing shareholders," increasingly foreigners.[18] But these payouts are made by sacrificing long-run investment.

Summary

Fiction: Productivity gains lower production prices over time.
Reality: Interest charges on debt pyramiding raise the cost of doing business by so much as to offset productivity gains, diverting revenue away from new investment and consumption.

The nation's highest-paid individuals work on Wall Street, where they devote an enormous amount of effort and even innovation to make money financially. Unfortunately, they are part of a system that has become dysfunctional for the economy at large. Financial gain seeking has been decoupled from long-term capital investment, and now undercuts it by being predatory.

Textbook formulae describing stock market behavior neglect the associated fiscal distortions that lead financial managers to load industry down with debt, and treat as "exogenous" the behavior of lobbyists backing politicians committed to shifting the tax burden onto labor and industry. There is little hint of how self-defeating the recent structural changes in the economy's financial and tax policies have been in polarizing property and wealth distribution and the incidence of debt.

Profits and capital gains are described as resulting from farsighted investors taking risks. But rather than being far seeing, the financial time frame is short-term. Speculators have survived by shifting the risk onto society ("taxpayers"), most notoriously in the post-2008 bailouts. As Cadbury-Schweppes chairman John Sunderland recently decried the situation in a speech to Britain's Investor Relations Society: "The pressure on the sell side has, in my view, made analysts very focused on the near-term … research tends to be more sensational, and on roadshows there is increasing pressure to put us in front of hedge funds rather than traditional long funds."[19]

By 2006, hedge funds were accounting for nearly half the trading flows on the London and New York stock exchanges, although they only owned a small percentage of equity in these two markets. Their aggressive trading has played a major role in subordinating the industrial economy to financial management.

18 "Japanese payout hunters face gamble on cultural change," *Financial Times*, March 30, 2006.
19 Stefan Stern, "The short-term shareholders changing the face of capitalism," *Financial Times*, March 28, 2006.

Mark Goyder, who runs the UK-based think tank 'Tomorrow's Company,' believes that … where 'shareholder value' may once have referred to the long-term creation of wealth, today's short-term financial investor demands action that can influence the share price even on a daily basis. Add in the misguided belief, known as 'agency theory,' that management's remuneration has to be closely tied to share prices, and you have a recipe for very short-term thinking."[20]

Misguided beliefs are not accidental. The natural tendency is to see matters realistically. Wrong-headed economics requires a blizzard of rhetoric to distract attention from the extractive character of today's financial markets. Euphemisms replace functional description, and the financial sector's first task is to deny in principle the idea of an economic free lunch. All debt is deemed "productive," that is, financing investment in the means to pay it off with the stipulated interest charge. Every sector of the economy is assumed to help every other sector grow, so that all income is earned productively as finance helps industry. The "proof" is simply to correlate the growth of rates of finance and the industrial sector. But one could just as well correlate these two time series with global warming, rising costs for health insurance or any other variable. The idea of causality has been left behind by today's post-modern mathematical fads.

This ideological set of blinders ("guidelines") has inspired academics committed to rationalizing the *status quo* to turn the word "risk" into a euphemism for almost any kind of free lunch. For investment bankers and corporate raiders, the main risk is that regulators may close the loopholes that make speculative "risk-taking" un-risky, while shifting the actual risk onto industrial companies and their employees—whose available revenue is shrunk by rising charges for debt service—and ultimately onto taxpayers via central bank and Treasury bailouts.

Financial lobbyists treat our financial situation and increasingly regressive tax structure as being natural and hence inevitable—and therefore not subject to change by earthly reformers. Their public-relations campaign promotes the idea that unregulated (and un-taxed) financial markets are all for the best, as if driven by an Invisible Hand. And they are not referring to the invisible hand of insider dealing (*e.g.*, that Eliot Spitzer's prosecutions revealed).

The preceding pages have described how the first myth in this economic fiction story is that the stock market raises money to provide companies with equity capital to build factories and employ more people. The reality is that investment bankers and speculators obtain most of the price established by

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[20] *Ibid.*

the end of the first day's trading of new public offerings. For companies already established, the stock market has become a vehicle for raiders to buy out stockholders and burden companies with debt, forcing companies to spend their earnings on buying their own stock to support its price.

The traditional industrial objective of corporate officers was to build up their company's net worth—the value of its plant and equipment, inventories, real estate and other investments over and above its debts. But since the 1980s, stock-market wealth creation has gone together with debt pyramiding. As long as financial managers find it easier to make money by stripping assets than by undertaking new direct investment, the debt burden will make economies more fragile. Only asset-price inflation kept the market value of assets high enough to cover the rising volume of corporate debt mounting up more rapidly than the value of stocks, the book value of assets or sales over the past decade.

The question is, how long can this continue? Which expansion path ultimately will end up higher: that of debt, or that of the assets bought on credit?

The answer from every historical epoch is that financial dynamics end up more powerful. And by deterring new capital formation, they often work in the opposite direction from technology. The resulting debt crisis disproves the assumption that people—or entire economies—recognize their self-interest. Yet this is the axiom on which free-market economics is based.

As noted earlier, the simplest cure would be to remove the tax-deductibility of interest charges. It is one thing for investors to buy real estate, stocks, bonds or other assets and make a gain; it is another thing to borrow freshly-created credit to do this, subsidized by taxpayers. (The subsidy ends up being used to pay the banks that create the credit.) As an Australian critic James Cumes recently observed: "In 1997, non-financial [U.S.] corporations paid $218.1 billion in dividends from $337.7 billion in after-tax profits. In 2002, they paid dividends of $285.8 billion out of sharply lower profits of $197.0 billion. In other words, they financed a substantial and growing part of their dividends by drawing on their cash reserves or borrowing. In past, more normal times, the distribution was about half and half—half after-tax profits went to dividends, half were undistributed. … Dividend payments have been rising to an all-time high as a share of national income, while profits, by the same measure, have fallen to an all-time low. Excessive and what would once have been regarded as highly imprudent dividend payments are now used to prop up overvalued stock prices."[21]

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[21] Note on Gang8 e-mail list, June 2006.

…tion: Income that is un-taxed will be invested productively to help the economy grow.

Reality: Income that is un-taxed will be pledged to pay more interest to banks and bondholders— and this bank credit will bid up the price of the real estate and corporate revenue that is being untaxed.

All this has profound implications for tax policy. Since the U.S. income tax was first enacted on the eve of World War I—with capital gains being taxed at the same rate as other income—business has waged a constant struggle to get untaxed, by shifting the burden onto labor and consumers. The argument is that lower taxes will leave more income to be reinvested, to earn more profits by hiring more labor to produce more goods and services to raise living standards.

The world now has learned that this is nonsense. The reality is that the real estate motto, "Rent is for paying interest," has become the corporate motto as well: "Corporate earnings are for paying creditors," in exchange for loans to buy companies or at least to bid up their share prices. The tradeoff is not over whether companies either will pay taxes or invest. It is between companies paying taxes to the government or interest to their banks and bondholders. Most business tax reductions have ended up being paid as debt service, thereby expanding the debt burden that business must carry, instead of reducing corporate costs and making industry more competitive. The effect is to divert more credit and savings to the financial sector, increasing the debt that financially leveraged companies must pay, and the resulting tax shift that the economy's labor and consumers must pick up.

What makes the downsizing of employment by today's financial managers so ironic is the avid support by pension funds as well as by mutual-fund small investors for takeovers, share buybacks and the general indebting of industry. Fund managers ostensibly representing the interest of retirees and labor have bought into the junk-economics myth that it pays to maximize the short-term performance of their stock portfolio, without regard for how this may impair long-term industrial investment and employment. Fund managers are told that to forego the drive for capital gains is a failure to use the financial portfolio to its "best" use. There has been almost no European-style attempt to use employee or consumer stock ownership to steer corporate policy in the interests of the labor force on whose behalf these stocks and bonds are held.

"In the beginning" and throughout all antiquity, industrial capital was self-financed. There was no productive lending to invest in workshops or other means of production, but only to finance trade in goods already produced. In the Bronze Age (before 1200 BC) most manmade capital was owned by the large economic institutions of the epoch: the temples and palaces of the ancient Near East. In classical Greece and Rome the civil governments or temples owned the mines, mints and basic infrastructure, and this continued to be the case up through the Renaissance. There was no public debt or debts owed by the temples or to the large estates on which the division of labor took place. Land as well as workshops and high-cost investments were owned outright. These assets might be leased out to private managers, but remained in the public domain—and debt-free.

The most productive banking was to finance foreign trade, as well as transferring funds geographically. Consumer usury was universally denounced, but lending to kings—mainly for war-making—legitimized domestic money lending. Still, finance refrained from participating in or funding the major innovations of the Industrial Revolution. James Watt could not get bank credit, nor could Henry Ford. The major innovators borrowed against their real estate, and from their families and friends for start-up capital.

Public investment in canals and other basic infrastructure was self-financed. At a local level, this was done largely by taxing property owners. Only after these capital investments became going concerns would banks be willing to lend against their property, sales and income stream already in place, not to create new means of production.

Almost without economic theorists or even historians noticing, the basic form of competition today is no longer primarily among industrial entrepreneurs to lower prices and undersell their competitors, as Joseph Schumpeter described "creative destruction" via technological advance. The competition today is among financial raiders to acquire industrial companies and turn their assets into debts, to be paid out to the raiders and the banks and bondholders who back them.

The drive for lower costs today is not one of technological advances in productivity as was expected a century ago. It is a drive to lower costs by lower wages, lower taxes—and lower financing costs under a distorted tax system by replacing "high cost" (but low break-even) equity capital with ostensibly "low cost" tax-deductible debt financing that raises break-even costs.

Every new economic system emerges from its predecessors. Finance capitalism emerged from the Industrial Revolution's industrial capitalism. But finance capital almost always has been antithetical to industrial capital formation, as well as to the much larger capital investment by the public sector in creating basic infrastructure such as roads and other transportation, ports and airfields, water and sewer systems, public utilities. These are being privatized and financialized today, and formerly public services provided at cost or freely are being replaced by tollbooths.

This is what has been happening to industrial firms taken over by financial managers since the 1980s. Instead of productive tangible capital investment in the means of production, finance capital produces debt to attach to existing assets in the public and private sector alike. It used part of the proceeds to buy control of government, above all by purchasing control of the electoral process and the mass media. The result was not only direct financial parasitism on the industrial economy, but cultural and intellectual parasitism to depict all this as being progressive and even part of natural evolution toward globalization—financial-style.

Tax favoritism for debt service treats even takeover debts as an inherent and normal cost of doing business. Yet the resulting financial dynamic is de-industrializing the United States, Britain and other economies that are "going financial." Returns are paid to bond and stock holders rather than being recycled into tangible capital formation. These payments are "crowding out" the commitments that these companies earlier took to defer labor's wages by paying pensions later on.

Labor leaders negotiated lower wages in exchange for future retirement payments. In exchange for reduced wage demands, employers agreed to set aside a portion of their higher cash flow and invest it in a pension fund, thereby giving workers a stake in their employers. So labor acted with foresight, preferring to take its return later in life. But financial lobbyists now assert that corporations are being made uncompetitive and even forced into bankruptcy by labor demands for unpayable high-cost pensions and health care.

The employers thus are breaking their word—or more to the point, new financial managers have taken over and claim that these promises made by past executives must be downsized. Raiders and other managers are paying out pension fund assets to backers, along with a rising share of profits and cash flow. The effect is to leave companies sufficiently broke that their managers claim that a *force majeur* emergency prevents them from paying. Labor unions are given the choice either to scale down their claims or have the company declare bankruptcy.

The effect of debt leveraging collateralizing all available assets is to leave companies in a high-cost position. Even healthy corporations have felt obliged to take on debt as a "poison pill" to deter financial raiders from taking them over and borrowing against their assets to pay themselves, leaving debt-ridden carcasses in their wake. Bankruptcy is a means of wiping out financial obligations to employees in order to pay large institutional creditors—while shifting their pension-fund and healthcare obligations onto the government pension-insurance agency.

The hypocrisy of the financial takeover movement is exemplified by New York (that is, Wall Street) Sen. Chuck Schumer. His Orwellian-titled Shareholder Bill of Rights Act of 2009 aimed ostensibly "to prioritize the long-term health of firms and their shareholders" as if these aims were identical. But as a group of corporate lawyers observed, the specific provisions of the proposed act would give shareholders the ability to carve up companies with debt, not heal them:

> Excessive stockholder power is precisely what caused the short-term fixation that led to the current financial crisis. As stockholder power increased over the last twenty years, our stock markets also became increasingly institutionalized. The real investors are mostly professional money managers who are focused on the short term.
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> It is these shareholders who pushed companies to generate returns at levels that were not sustainable. They also made sure high returns were tied to management compensation. The pressure to produce unrealistic profit fueled increased risk-taking. And as the government relaxed checks on excessive risk-taking (or, at a minimum, didn't respond with increased prudential regulation), stockholder demands for ever higher returns grew still further. It was a vicious cycle.
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> ... Institutions should discontinue the practice of compensating fund managers based on quarterly performance. And corporations should follow the lead of General Electric by discontinuing the practice of issuing quarterly earnings guidance.[22]

The problem is that bank credit has played an increasingly intrusive rather than productive role in recent centuries. To cap matters, it has become outright parasitic in organizing today's leveraged buyouts (LBOs), creating computerized credit default swaps, arranging tax-avoidance money laundering and lobbying for tax subsidy for debt financing—to be paid by imposing austerity on the economy at large. At the end of this road lies bankruptcy for companies, wipe-out of their pension plans (beyond the ability of the Pension Benefit Guarantee Corp. to pick up the pieces, given its reticence to levy risk premiums proportional to risk), and finally bank insolvency as debt deflation shrinks the economy and forces borrowers to default. At that point the banks demand public bailouts at taxpayer expense, shifting bad private-sector debts onto the public balance sheet. So entire economies are crippled even more. The bankers' last act is to take what bailout money they can and run. This is

[22] Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, "Schumer's Shareholder Bill Misses the Mark," *Wall Street Journal*, May 12, 2009.

what they did in QEII in summer 2011, reportedly sending the entire $800 billion in new Federal Reserve credit abroad in foreign-currency interest rate arbitrage.

The "internal contradiction" in financialization is that while it "extracts value" from companies for the raiders, the debt that it creates raises the break-even cost of production. So debt-leveraging an industrial company has a similar effect to taxing it more, or raising wage levels: unless it has monopoly power, it is priced out of the market.

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There is only one way left to continue: to globalize the financialization process, spreading the tactic to other countries so that everyone's cost of production rises as industrial firms across the world are loaded down with debt to enrich a financial overclass. This is what is occurring today. But it is a dangerous tactic. Other countries may resist. And by promoting equity rather than debt financing, these economies will out-compete the more debt-ridden, financialized economies. Without a mutual financial suicide pact at this point, the tendency toward global free trade will be blocked.