"Absentee Ownership in America"

Cameron Weber, February 1, 2012

This article makes the case that the main problem with the economy of the United States of America is first, the tax code, and second, the central bank. The US Income Tax, ratified by the states in 1914[1], allowed the write-off of interest payments on debt from corporate and personal income tax. At the same time this new Income Tax taxed equity (the returns to ownership of a company) twice. This double tax on equity and write-off on debt has encouraged the build-up of debt in the American economy. Marxists call this the "financialization" of the economy. Libertarians call this "socialized risk and private returns" as it has worked-out in practice with bailouts. And, this is what Veblen, presciently, called "absentee ownership" in 1923.[2]

The tax code has encouraged the build-up of debt in the economy, instead of the build-up of equity. This prioritization of debt over equity has meant that a management class has evolved who manage large public corporations. This "class" sell debt-based financial instruments (bonds and debt derivatives) to each other, for a fee (profit), because the interest-payments on these debt instruments can be written-off on corporate income taxes.[3] By creating debt and selling it to each other, while writing-off the interest payments on the corporate income tax, this management class can earn high salaries and bonuses.

Large public corporations have the incentive to build-up their businesses by using debt instead of equity, because this "financialization" rewards a fee-based profit (and subsequent bonuses) to the managers who create this debt. Companies need to be seen as growing in order to attract equity capital, the basis for debt-leveraging, and creating debt grows a company.

Debt becomes such a large proportion of the corporations relative to the equity that the equity owners don't have the incentive to monitor their ownership interests.[4] This "absentee ownership" evolves because the equity-ownership

---

[1] The Federal Reserve central bank started operating in 1914 as well.

[2] *Absentee Ownership in America* by Thorstein Veblen 1923.

[3] The tax write-offs of mortgage debt for home-ownership is also what helped caused the Great Recession of today but that is not our specific focus in this short article.

[4] Nobody is minding the store, so to speak. Ownership in publically-held corporations is called "equity" or "stock". The largest "class" of stockholders in the USA is pension- and insurance-fund money.

portion of the capitalization is such a small proportion of the overall capitalization.[5] This prioritization of debt over equity in the economy results in debt to equity ratios of 10 to 1, or 20 to 1, meaning that equity is only 5 or 10% of the value of a corporation. Taken economy-wide, this means that the economy has created debt which is 10 or 20 times greater than the equity in the economy. The economy has become "financialized".

A wholly-owned business means that the owner (or owners) has a full-ownership incentive in assuring that the business manages its risks and benefits from their business activities directly.[6] The management class in large corporations does not have these incentives or limitations fully. They can run-up the debt and dilute ownership interests while at the same time earn large profits/ fees/commissions for themselves without fully internalizing the risks they are creating.

It is indeed "absentee ownership" because the tax-code has created debt over active stock-holder self-interest. The management, debt-creating class, can run-up debts and create profits/bonuses, until there is a financial crisis. Crisis is the result of debt-based financial *bubbles* (caused in part by central bank expansionary monetary policy) and *busts* (caused in part by central bank tightening of monetary policy).

Debt is very sensitive to interest-rate changes so the value of debt changes greatly, both up and down in value, as the central bank changes interest rates. However, unfortunately, periodic financial crisis has not resulted in a change in the tax-code which creates these absentee ownership -based crises in the first place.

This "socialized risk and private return" occurs because large consolidations of debt are deemed "too big to fail" and subject to implicit bailouts. As stated, the "absentee ownership" economy and concomitant periodic crisis is encouraged by the Income Tax code and central banking monetary policy.

---

[5] "Capitalization" is another word for how a company is funded, and includes both debt and equity. The total of the debt and equity is a corporation's "capitalization". If the corporation has $1 million in equity (the value of its stock on the stock market) and $10 million in debt (it has borrowed $10 million), then its capitalization is $11 million.

[6] 50% of Americans work for large corporations of over 100 employees and 50% work for, or own fully, small, non-corporate, businesses of less than 100 employees. Smaller businesses tend to grow faster than do large corporations.

Accounting Example of Equity Taxed Twice and Debt as Tax Write-Off:

	Ad Hoc Financial Statement for Firm X	
	Revenues	$100
	Expenses	70
	Gross Profit	30
a.	- Debt Interest	10 (Interest as *write-off* on tax code)
	Net Profit	20
	Taxes 30%	-6 (20 x 30%)
	Net Profit After Tax	14
b.	Dividends to stockholders	10
	Retained Earnings	4

	Personal Income Tax for Person Y	
	Dividend Income	$10 (from *b.* above)
c.	Taxes 15%	$1.5 (10 x 15%)
	Net Income	$8.50

First, *a.* represents a pre-tax *write-off* of corporate debt. Then *b.* represents equity dividends paid-out by the corporation *after* corporate income tax has been paid on the equity profit. Then *c.* represents the taxes paid on the equity profit a *second time*, this time on the personal income tax by the person receiving the equity dividend. Therefore interest on debt is a write-off on the tax code, whereas equity is taxed twice under the tax code. Because economic actors respond to policy incentives, the tax code encourages debt build-up over equity interests, resulting in *financialization*, *absentee ownership* and periodic financial crisis.