WORLD BUSINESS ACADEMY
Sharing the Vision... Building the Network... Healing the Planet

PERSPECTIVES

by Rinaldo S. Brutoco

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Fixing Wall Street: Debt vs. Dividends

We frequently hear on public media that "the stock market does not reflect the 'real' economy." That is absolutely correct. The question we should ask ourselves is why doesn't Wall Street reflect the real economy? Why is Wall Street today at all-time highs when we are now in the worst recession since the Great Depression, sitting literally on the edge of a new depression here in the USA and around the world. There are over 30 million Americans out of work, and the market is "up"! The pandemic is ravaging our society and destroying our economy, yet the stock market maintains its artificially lofty price points! Oh, and in case you are wondering whether the current "asset bubble" will burst with an attendant stock market bust, it will!

Main Street is hurting worse than any other time since the Great Depression, so why is the stock market acting as if everything is great? The answer is quite simple: the stock market has almost nothing to do with economic reality and almost everything to do with ongoing market manipulation. How does that happen? To understand that, you have to understand that Wall Street is fundamentally a giant casino. It's worse than Las Vegas. In Vegas you can learn the odds and potential loss on whatever "game of chance" you select because the specific returns to "the house" are calculated for each form of gambling. I'm not sure if this is still the case, but the last time I checked, slot machines at major casinos were programmed – yes programmed to return 75 cents for every dollar a "gambler" put in. In other words, for anyone to win 75 cents, some other sucker in the room has to lose a dollar. In fact, the biggest difference with Wall Street is that your odds of winning are much lower than in Las Vegas. Unlike Las Vegas, no one is regulating the way the rules get changed to benefit Wall Street insiders even while the "gamblers" are playing. That is illegal in Vegas but considered smart behavior on Wall Street.

There are many ways Wall Street is "rigged" for insiders that we'll be highlighting in other columns in this series on "fixing" Wall Street, including addressing Programmed Trading, political corruption that allows for totally inadequate "capital market" supervision, and the freedom to drop companies out of an index when they start to perform poorly to maintain the appearance of the stock market as constantly going upward (when in fact it would be going down if not allowed to drop poor performing companies). We will also address the inadequate supervision of "Insider Trading" and a number of other features which keep the stock markets from reflecting economic reality or the harsh situation now facing Main Street.

All of those issues, however, pale in comparison to the single largest underlying marketplace distortion: the incredible way we treat interest on debt as desirable and dividends on equity as unequal.
Due to the unequal way that debt and equity are treated in the tax code, the financial system has developed to promote debt at the expense of equity. That is exactly opposite of why the stock markets were originally created, and even opposite of how the modern economy began with institutions like Lloyd's of London, The Virginia Company, The Hudson Bay Company, and all of the early corporate issuers both before and after the 30s.

Created over many decades of constant lobbying by the banks, the tax code was dramatically "loaded" in favor of borrowing over saving– of debt over equity. The base of this harmful inequality of debt and equity is the fact that a corporation can deduct the payment of interest from taxable income but cannot deduct the payment of dividends to shareholders against taxable income. Hence, it has become increasingly powerful to build companies leveraging off of debt for which interest can be deducted rather than by accumulating equity (either through the sale of equity or from increasing retained earnings) since dividends suffer from "double taxation:" the company gets taxed on its income and the shareholder is subsequently taxed on receipt of a dividend.

This puts an enormous bias into the market in favor of speculation. Why? Because the purchaser of a stock today is primarily buying on the assumption that the stock will be worth more tomorrow than today. That person is a speculator, not a real investor.

How is stock valuation accomplished? By multiplying the earnings per share of a company against the total number of shares outstanding to determine the market capitalization. Earnings go higher if debt is used because the capital to build the business is being borrowed, and because the cost of that debt—interest– is deductible. If the same company decides to attract a true investor as opposed to a speculator, it has to be willing to pay dividends so that the purchaser can hang onto the stock for decades and make an adequate return on owning the shares. The dividends going to an investor, however, are not deductible and will depress reported earnings. Therefore, this produces a lower market capitalization for the company which usually means that management will receive smaller bonuses as those bonuses are based on rising income and share prices. Both increase if debt is used to build the business rather than equity.

This divergence of interest between debt and equity explains why shareholders no longer "buy and hold" a stock for decades. Unfortunately, since making income and returning money to the shareholders are not on an equal footing, the entire corporate system in the US is based on speculating what will go up, or down, on a moment to moment basis. The stock market merely reflects the dominant speculative trends in the marketplace. That's bad for the markets, and really bad if we want to reduce speculation and return the markets to reflecting how the underlying economy is really doing.

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