Exploding Equities and Class Analysis

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Abstract: This paper represents an attempt to use the class analytics developed by Stephen Resnick and Richard Wolff (Knowledge and Class: 1987) to understand the explosion in US equity prices from 1982-2000. The analysis will be divided into fundamental, subsumed and non-class revenue effects stemming from the unprecedented run-up in equity prices. Lesser attention will be paid to the equally important conditions that supported this "new era" in equity performance. The simultaneously supportive and contradictory effects of rising share prices on various types of firms well highlights the particular insights gained from the employment of class analytics.

The New Era – Explosion in Equity prices 1982-2000

Nearly all indexes designed to measure the aggregate performance of American equities have seen historically unprecedented increases in the last 18 years. The Dow Jones Industrial Average (DJIA), National Association of Securities Dealers Automatic Quotation Composite (NASDAQ) and the Standard & Poors 500 Index (S&P) have registered the largest and most sustained inflation adjusted gains in their various histories.

The S&P 500 closed September of 1982 at 120.42 and stood at 1459.6 on September 18, 2000. Inflation adjustment does little to diminish this astonishing rise. The DJIA and NASDAQ have seen similarly spectacular gains. Mainstream economic analysis holds that equity performance is determined in the long run by three factors. The three factors are, real earnings, dividends and interest rates. A brief look at the performance of these factors fundamentally questions theories so based. Corporate after tax earnings have advanced during this period and doubled between 1992 and 1997. Earnings growth alone does not go far in explaining the astronomical advance in share prices. Dividend payment have averaged 1.2% of price, well below the 4.7% historical average.Real interest rates, while fairly low, have not behaved aberrantly during this period. Post-Keynesian analysts have advanced interesting theories based on Hyman Minsky's notions of financial fragility and financial innovation. However, this recent boom in equities is yet to be subjected in class analysis. What follows is an attempt to begin this project and highlight the unique insights this theory advances.

Equities in the Marxian Tradition

Marx devoted lengthy passages to the implications of the rise of the joint stock company. This attention focused on the class implications of the new form of organizing capitalist firms. An important separation between the ownership and operation of capital was theorized to occur with the joint stock company. The functioning capitalists, the board of directors were separated from the owning money capitalists, shareholders. This facilitated a rapid growth in the capital employed in the firm and socially. The industrial age witnessed the emergence of enormous private firms able to undertake massive and global projects as never before. The immense capital required for such undertakings was provided by emergent banks and equity markets. Massive investment was made possible through the pooling of vast amounts of capital inside the new joint stock companies. Banking, bond and equity markets blossomed making possible the development of industry on a hitherto unknown scale. Now, as then, we are living through a massive centralization and enlargement of banks, bond and equity markets. Once again, these financial developments are facilitating the emergence of truly massive and global enterprises. Marx introduced an understanding of the significance of the changing structure of ownership in enterprise. The role of finance in influencing and being influenced by, production is explored throughout the later two volumes of Capital.

The creation of fictitious capital through the speculative bidding-up of shares was noted for its potential to create investment funds and rapidly destroy and undermine investment. The highly volatile creation and destruction of credit money or, paper wealth, is thoroughly treated by both Marx and Hilferding. The role of major banks and industrial firms in manipulating this was seen as central to the process. Money capitalists intent on high dividends and speculative gains from asset price inflation may pursue policies supportive or contradictory to the needs of productive firms. Equity issuance provides firms with access to money capital. Dividend payments represent claims on SV gleaned in production. This can strain and threaten the ability of productive firm to continue producing SV as well as facilitate accumulation. Similarly, rising equity prices are associated with the devotion of an increasing portion of the total social capital toward unproductive ends. This necessarily tends to limit the capital that enters the valorization process. However, vast increases and technical improvements in productive capital can be funded by fictitious capital. Thus, the gyrations of credit money extend the possibility of great gain and profound loss. The needs and desires of productive firms spur periods of gain and precipitate painful contractions. This occurs in a rapidly changing context in which the needs of finance and industry move in and out of harmony with potentially calamitous consequence.

Rudolph Hilferding and Suzanne DeBrunhoff added to and enriched Marx's work through analyses of finance and banking and the relationship of these processes to the capitalist fundamental class process. The role of the great banks of the European industrial revolution is sketches as concomitantly providing bold expansion opportunity and ruinous debt burdens. Lenin began a long tradition on the left of exploring the powerful and possibly overarching role of banks in 20th century capitalist society. To this I would like to add a fairly detailed look at the extent to which history’s latest and perhaps greatest, equity market boom has affected the fundamental, subsumed and non- class processes in the US.

Toward a Class Analysis of Equity Markets

The Capitalist fundamental class process involves the production and first appropriation of value and surplus value. Fundamental class firms are those that engage in the process of producing goods and services and privately appropriate the value and surplus value within the goods and services. The total labor time expended in the production process is divided between that which is paid its value – the wage and that which is not paid for, surplus value. The board of directors then takes possession of the surplus value. In order to create the conditions necessary to allow the continued exploitation of labor, fundamental class firms must distribute the surplus value created in the production process. The modern corporate board of directors is formally assigned this task. It is the board that appropriates and makes broad distributive decisions regarding surplus. One of the many payments fundamental class firms make in return for the provision of conditions of existence is interest in return for access to money capital. Surplus Value must be distributed to lenders of money capital in the form of interest and fees.

Productive firms raise money through many channels. Loans and loan guarantees are only one way for firms to access money capital. Stock and bond issuance have become extremely important sources for many firms over the past century. Investment banks and brokerage houses, often combined into single firms, can provide an alternative or supplementary finance channel. Investment banks have the unique ability to grant firms access to the wealth of stock and bond investors – institutional and individual. This provides firms with an alternative source of money capital. In periods, such as the last 18 years, enormous pools of money sat available to those able to get access to the large American equity markets. Money raised through these markets too requires the payment of a portion of the surplus. Investment banks require fees in return for their vital services. Depending on the state of speculative fervor equity issuance may or may not be profitable or possible. This process is defined by the payment of SV, gleaned in the fundamental class process, in return for conditions of existence.

The astonishing rise on equity markets over the past 18 years has had a profound effect on fundamental and subsumed class firms. Marxian class analysis offers a unique and different way to understand this process.

Access to Money-Capital

Fundamental class firms have many needs for money capital. Expansion and existence often rest on access to money-capital to settle all variety of payments and grow. Many businesses are born of and die from a loan. That said, fundamental class firms must often borrow money. This money-capital is a condition of existence of the fundamental class process and must be paid for out of the SV produced. So common is that practice that their exists a special term associated with this subsumed class payment, interest. Fundamental class firms are constantly engaged in the struggle to gain access to this needed money capital while paying the lowest possible interest rate. Enter a booming equity market.

One way that firms gain access to money-capital is through the public offering of shares. This offering or IPO allows a firm access to money-capital, a condition of existence. This must be paid for. The issuing firm must distribute a portion of it SV to an investment bank and brokerage house in order to gain access to the equity markets. This payment of SV by the fundamental class firm forms a portion of the income of the investment bank and brokerage house. If the IPO market is hot, firms will be able to more easily raise money through this avenue. In addition, shares will be priced higher on average, allowing for increased access to capital. This is but one of the ways that exploding equity markets help firms.

Once shares have been issued firms may select to pay dividends to their shareholders. Dividends are another subsumed class payment. A portion of the SV generated by the firm is distributed to the shareholders as a condition of existence-continued access to money capital through equity markets. The last 18years has borne witness to declining dividend payment the dividend payout among the S&P 500 over the last 15 years is less than 33% it average since 1870. Capital gains, recently stellar, form the other reward to share ownership. When prices boom, as in the recent past, the demand for and need to make dividend payments falls. This allows the firm to lower its payments for conditions of existence. This can be seen as akin to lowering the interest rate charged to fundamental class firms. **However, investors have grown accustomed to high returns and may demand dividends or flee ownership absent the capital gains earnings they have grown used to.**

The enhanced ability of major firms to access money capital through public offerings has had profound implications for traditional commercial banks and smaller firms. Those fundamental class firms unable to access equity markets have found themselves at a decided disadvantage relative to larger competitors who have such access. Commercial banks, like investment banks and brokerage houses receive much of their income in the form of subsumed class payments from firms seeking access to money capital. Commercial banks – bared by the Glass-Steagall Act- from underwriting shares have watched as traditional clients opt for stock issuance instead of commercial borrowing. This has forced commercial banks to lower the interest rates that they charge and look to other sources of income. In addition, many smaller commercial banks have either failed or been purchased. The epidemic wave of bank failures in the 1980's and early 1990's well illustrates the pressures under which non-investment banks have operated. The explosion of personal indebtedness among American citizens and predatory lending throughout the world has resulted. In addition, massive margin lending has been substituted. Banks lend to buyers of stocks and bonds, often willing to pay high rates of interest with their shares as collateral. Banks, long massive players in equity markets have also stepped their equity holdings.

The competition between investment and commercial banks has resulted in massive indebtedness among segments of the American and international population long seen as uncreditworthy. Additionally, commercial banks have increased their exposure to the risks and rewards of equity markets through direct purchases of shares, margin lending and most recently the purchase of investment banks and brokerage houses. The creation of Citigroup – in open violation of the glass Steagall Act- well illustrates this trend. It is worthy of note that the separation of commercial and investment banking was born of the massive wave of failures in these institutions falling from the great crash of 1929.

Managerial Salaries

Fundamental class firms must distribute a portion of the surplus value that is generated in the production process in the form of managerial salaries. The firms managers provide essential services. They plan and oversee production from before the actual production process begins to well after the goods or services are produced.

However, managers do not produce value of surplus value, they are unproductive employees of the firm. Over the past two decades firms, including many fundamental class firms have discovered a way to handsomely reward managers without paying them out of surplus value. The age of stock options is upon us. The ability of firms to pay people with stock options is possible, if and only if, managers believe that the firm's stock price is likely to rise well above the option price. For the past two decades this has been true. Lavish options are granted instead of high salaries. Thus, the speculative increase in the value of the firms shares acts to reduce the payment firms must make to managers while still granting managers lavish compensation. In addition, US tax heavily rewards this practice by taxing capital gains income at a lower rate than earned income and allowing firms a massive tax deduction based on this practice. The banks, insurance companies, pension funds and speculators that buy shares are thus subsidizing the firm's managerial expenses.

The recent extension of this practice to non-managerial employees only further benefits firms. Stock options are sometimes granted to employees as a form of the wage or retirement allotment. In this case, equity inflation is substituting for wage payment. The firm may be able to reduce the portion of the value created by the employee that is paid as a wage. This would be an example of an increase in the rate of exploitation made possible by rising equity prices.

Accumulation/Mergers and Acquisitions

Fundamental class firms operate in an environment deeply influenced by struggles for profit, market-share and survival. In such circumstances growth is often seen as providing competitive advantage. This phenomenon, sometimes referred to as too big to fail, is witnessed among subsumed and non-class firms as well. There are 2 principle routs to growth. The first being distributing a portion of SV toward increased purchase of capital and labor, accumulation. The second, is the purchase of existing firms, acquisition. Booming equity prices tends to effect both of these processes. The distribution of SV toward increased capital and labor acquisition competes with all other claims on surplus value. Anything that lowers other claims aids accumulation. If booming equity markets tend to reduce interest payments and the salary demands of managers, firms will have more money to devote to accumulation.

The acquisition of existing firms is both promoted and made more expensive by booming equity markets. The number and scope of acquisitions in the past two decades is unprecedented. Firms have come, increasingly in the last 18 years to use stock as the currency of acquisition. There have been $1.32 Trillion worth of mergers in the US from January 1, 2000-September 16, 2000. Such mergers have tended to rely on stock valuation and have been particularly hectic among investment banks and brokerage houses and within the auto industry. These majors often take advantage of the lofty prices of the acquirer's stocks. This allows firms to rapidly enlarge themselves and their ability to produce SV or attract subsumed class payments. This is made possible through the recent explosion in equity markets. In the high-tech industry the endless purchase of small firms is so common that only the largest acquisitions and mergers are covered by the business press. No single merger more speaks to the power of inflated equities than the purchase of Time Warner by AOL. A smaller firm, in terms of book value and earnings bought a larger more established firms using its wildly inflated common stock.

While the above advantages gained by firms from high stock prices are noteworthy they pose a serious threat. A firm's survival is now threatened by a falling equity value. Unwanted takeovers are very difficult to fend off when shareholders are angry about capital losses or stagnant performance. The expectations of shareholders have been driven to untenable highs in the last two decades. These expectations, when unmet, can and do cause rapid and severe equity price penalties. In addition the relatively high value of the acquirers equities act as a powerful draw to major shareholders. The financial fragility of firms is massively heightened in such an environment. Meeting the inflated demands of equity holders has become a life and death decision for many firms.

Tax Implications

Wealthy individuals and publicly traded companies have reaped massive tax advantages from the recent run-up in equity prices. As noted above, the payment of managers in stock options has reduced the SV going to managerial salaries will manager’s compensation packages have exploded. In addition, the low rate of capital gains taxation increases the take-home pay of executives. However, the exercise of such options further increases volatile equity markets as other investors flee stocks when huge insider sales come to light. This is however only the beginning. Firms have saved billions of dollars in taxes through substituting stock options for salaries and wages. A bizarre loophole in US tax law allows firms to deduct the difference between the option and strike price. This difference between the price that the equity is purchased at by the employee and the price at which it is sold is tax deductible. This allows firms to deduct against their federal taxes the equity inflation driven compensation they offer employees.

Booming equity markets thus, allow firms to reduce their taxes while having eager speculators bid-up the value of option packages granted to employees. This reduces the subsumed class payments that firms are forced to make to the federal government. This frees up a portion of the SV that would otherwise go to paying federal taxes. Meanwhile the government continues to provide conditions of existence to firms.