

# How Economists Are Missing Another One

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Paul Krugman explained, in “How Did Economists Get It So Wrong” (*The New York Times Magazine*, September 6, 2009) how economists’ oversimplifying assumptions and models led to the present crisis by hiding important realities of the financial system and the real economy. He also described differences between the “salt water” economists at universities along the Atlantic and Pacific coasts and the “fresh water” economists of the Middle West, particularly the University of Chicago.

Today’s crisis grew out of problems on the credit and consumption sides of the economy. This essay builds on Krugman’s article and explains why problems on the equity and production sides, that few economists, political leaders, or corporate executives seem to understand or are willing to admit, are likely to cause another crisis.

Most salt water economists agree that creating jobs on Main Street is important. That will require extensive private sector investments, but the term “investment” has several meanings that can hide the different ways that stocks can affect jobs, wealth distribution, and the economy. The differences stem from three aspects of stock investments; *types of investment*, *investors’ objectives*, and *stock flows*.

## **Types of stock investments**

Stock investments are *productive* or *parasitic*. The line between them can be fuzzy sometimes, but the differences are usually clear. Productive investments, which are called direct investments when made in other countries, provide capital to start and expand businesses in the real economy. They pay for the things, knowledge, and services that a company needs to operate. Young companies that are intended to become large need productive investments that usually come from the founders, their friends and families, and early stage investors such as angels and venture capitalists who take active interests. Because investments in these young companies involve many risks and are hard to liquidate, the companies depend on stock and rarely borrow very much. If they are successful, they may raise more productive capital from an initial public offering (IPO) and maybe from secondary offerings. If they continue to grow and establish a credit record, they may borrow money for productive investments, but equity capital is required for most early stage development.

In contrast, most stock purchases by individuals and institutional investors are parasitic investments because the buyers just want their money to grow. They are not interested in who gets their money or how it is used. They may buy stock of specific companies or they may buy shares of mutual and exchange traded funds that in turn buy companies’ stock. In any case, their money goes to the former stockholders, not to the companies. These are parasitic investments because they contribute little to the companies but piggy-back the productive investments that others have already made. And as will be discussed, they may be harmful and lead to eliminating rather than creating Main Street jobs.

## **Investors' objectives**

Five primary reasons for obtaining stock are for *control* of a company; to receive *current income* from its operations; for *price gains*; to store *future purchasing power*; and to *create money*. Company founders typically believe they know best how to manage their new enterprise, so they take large blocks of stock before the IPO in order to retain control. Similarly, outsiders who want to influence or take over a company may buy large amounts of its stock on secondary markets.

Income from dividends used to be a major reason to buy stock for the long term, but in the early 1980s, emphasis shifted to “total returns” which were dominated by price gains. S&P 500 Stock Index data show that 1981 was the last year after 1925 when the sum of all dividends paid was greater than the gains. The shift was profitable for Wall Street and coincided with the emergence of 401(k) retirement plans which emphasized growing portfolio values. Now, most stock purchases are for short term gains.

Retirement plans are the dominant stock buyers today, and their purpose is to build future purchasing power. But the plans have hurt Main Street and have fatal flaws which will be discussed below.

Finally, despite the general understanding that companies issue stock to raise money, their main reason is literally to create a form of money.

## **Stock flows**

Individual and institutional investors buy most of their stock on the New York Stock Exchange, the NASDAQ and other secondary markets. Only small amounts of stock are bought directly from companies through public offerings. My analyses of Federal Reserve Flow of Funds Data indicate that after companies have their IPOs, most of their shares come to secondary markets when insiders sell them. This will be discussed below because it has major wealth distribution and other effects that few people understand, economists ignore, and those who benefit try to keep from being discussed.

## **Creating money with stocks**

The reckless expansion of credit that led to over-consumption and the housing bubble has been widely discussed, but comparable mistakes with stock are being ignored. Creating money is the best place to start applying the three aspects of stock investments listed above (types of investment, investors' objectives, and stock flows) to show how stocks can affect jobs, wealth distribution, and the economy.

It is natural for the founders of a company to want to keep control of their baby, so they can easily justify taking large blocks of stock before the IPO. Right after the IPO, however, all shares are treated as being worth the market price and if the founders took enough, their paper fortunes can make them rich in a day. Most recent fortunes have been made by (figuratively) printing stock certificates and passing them as money in what amounts to a legal form of counterfeiting. Few economists or public officials have recognized how this process expands the money supply while reducing the national savings rate, and almost no data are published to track it. Entrepreneurs need incentives to take risks, but there are serious questions about how large the incentives should be and how they should be taxed.

Insiders convert their paper fortunes into cash by selling the stock. Aggregate data for this are scarce, but it is how most stocks come into the market. The efficient-market hypothesis

(EMH) does not consider how insiders drip feed stock into the market, pacing the sales to maximize their returns while not overly depressing the market.

Bill Gates, the richest person in the world, is the extreme example of this. He took 45% of the Microsoft stock before the company went public in 1986 and has been selling ever since. During the first eight months of 2009, he sold 60 million shares for a total of \$1.2 billion. He more than recovered his investment from his first sale during the IPO, so all of his receipts are profit and are now taxed as capital gains at 15%. He still had 713 million shares as of August 18, 2009, which at the average price he received this year is a paper fortune of more than \$14.7 billion. Like many other companies, a primary goal of Microsoft is to create personal fortunes using its stock, and at one time there were an estimated 10,000 “Microsoft millionaires.”

## **Retirement plans**

Retirement plans exist to provide earnings streams to retirees. After 1982, Wall Street began promoting stocks as retirement investments by emphasizing their “total returns” which are driven by stock price growth more than dividend payments. Largely as a result of this change, stock prices were inflated in terms of their price-to-dividends and price-to-earnings ratios until the market peak in early 2000. Today, retirement plans of all types own nearly two thirds of the publicly-held stock traded on U.S. markets, but three important points are being overlooked.

First, as retirement plans bought stocks, almost no one asked where the stocks were coming from and where the retirement savings were going; or to put it another way, if stocks were such good long term investments, who was selling them and why? The answer, which few people including economists and political leaders seem to know, is that insiders like Bill Gates and his associates sold most of the stocks that the plans bought in order to convert their paper fortunes into cash. Despite Wall Street claims, retirement plans invest little in companies. Instead, the plans buy stock that insiders sell, thus transferring middle class savings to the richest people in the country and increasing the wealth gap.

The second point is that except for small amounts that some pension plans put into venture capital funds, nearly all stock investments by retirement plans are parasitic. As money flows in to plan managers who are expected to make it grow, they buy stocks and pass the pressure for growth on to companies. The companies respond by cutting costs, downsizing, outsourcing, laying off domestic employees, abandoning communities, promoting globalization, and going global themselves, all to inflate stock prices.

A recent example of these harmful effects grew out of the search for higher returns by pension systems. When stock prices stopped rising, they turned to “alternative investments,” including miss-named private equity funds which are actually leveraged buy-out operations. These LBO outfits acquire a company with strong assets including cash but low stock prices; sell some of the assets; close down operations and eliminate jobs to cut costs; extract the cash with dividends; borrow large amounts to pay for the process; and sell the companies back on the market in a weakened condition. The LBO outfits and pension plans are the winners, while companies, their employees, and their communities are the obvious losers. Less obvious are the companies that have learned not to look healthy enough to attract LBO attention.

The net effect of retirement plans’ buying insiders’ stock and parasitic investing has been to shrink both the production side of the economy and the middle class. The shrinkage was partly hidden while borrowing financed the housing bubble and excess consumption. Now, the country is trying to end the recession and create jobs, but the production side of the economy is

crippled. Rebuilding it will require massive productive investments in companies and even new industries to create jobs that will be harder to export. People are being advised to save more for their retirements, but almost none of their savings that will be handled by retirement plans or Wall Street will become available for the productive, equity investments that will be needed to create jobs.

The third overlooked point about stock-based retirement plans that is until their stocks are sold, their portfolio values are just phantom wealth that can simply vanish, as it has done twice in the past ten years. Whether or not the plans can be successful will be determined by the demand for stocks and supply offered for sale when boomers want to retire. This leads to the fundamental flaws in stock-based retirement plans.

### **Retirement plan flaws can lead to another crisis**

One of the worst things that could happen in the near future would be for stock prices to return to their former heights because that would restore confidence in stock-based retirement plans. These plans have at least eight fundamental flaws.

1. They are built on a stocks-for-retirement cycle. Most baby boomers are in the front, or buying half of the cycle, and to receive retirement incomes, they will have to shift to selling their stocks for substantial gains in the back half. This makes the cycle a national Ponzi scheme because returns to early investors (boomers) must come from money paid in by later investors (younger workers), not from companies as dividends.
2. When boomers gradually shift from buying stocks to selling them, the primary domestic buyers will have to be the younger workers that some believe will not be able to sustain Social Security in its present form. Stock-based plans and Social Security are joined at the hip by the same demographics—if stock based plans can work, there will be no Social Security problem, but if Social Security can't work, neither can the stock-based plans. Despite urgings to boomers to save more and buy stock, the future of their plans will be determined as much by the saving and stock-buying habits of younger workers as by the boomers' own actions.
3. There has been a symbiosis between corporate insiders and boomers' retirement plans. The plans wanted the insiders' stocks and the insiders wanted the boomers' money. As the boomers' plans shift from buying to selling, the relationship will end and they will have to compete with insiders who will still be selling. This will add more downward pressure to stock prices in what may become a sustained bear market.
4. Boomers are told to plan to stretch their stock sales over many years, but if there is a serious bear market, some of them may decide to get out quickly and save what they can. This, of course, would feed the bear.
5. Boomers' retirement plans that will have to sell stock suffer from the fallacy of composition; while some might be able to build and store future purchasing power individually, all of them can not do it collectively. Retirement income cannot be stored for a whole generation. It is a flow that can only come from other flows like employee and company earnings, which is why there appears to be a Social Security problem.
6. If there were an accepted due diligence analysis or feasibility study that explains how the boomers' stocks-for-retirement cycle can be expected to work, Wall Street would quote it

like a mantra. But there is no such document, so when asked, Wall Street changes the subject.

7. The plans are based on the same mistake of anticipating ever higher asset prices that led to the housing bubble. There is no accepted explanation of how stock prices can increase more than the economy grows for several generations, but this must happen for younger workers to pay adequate prices for the boomers' stocks and then sell them at a profit to pay for their own retirements.
8. In a 2002 paper titled "Demography and the Long-Run Predictability of the Stock Market," John Geanakoplos of Yale and two salt water associates from the West Coast explained that there has been a close relationship between stock prices as represented by price-earnings ratios and the ratio of young and old adults in the population. They predict a long bear market when boomers switch to selling.

The termination of thousands of company pension plans and the sorry shape of many state and local plans are evidence of these flaws. Any one of the flaws should be enough to make economists, corporate and government officials, and Wall Street question boomers' plans before they all fail. But instead of answering questions, they avoid them.

### **What's left?**

Like fractals, the picture is similar at any level of detail. Few boomers have saved nearly enough to hope to retire for many years; despite Wall Street predictions, their stock-based retirement plans have done little for the past ten years; their savings in houses have declined; and ultimately the stock portion of their retirement plans are likely to fail as many pension plans are failing now. Many boomers will have to work more years than previous generations.

Governments typically approach employment problems with training programs, but unless jobs are created, training will be useless. Massive, productive investments must be made in new industries to create the middle class jobs with adequate pay and benefits that boomers, those who lost their jobs in the recession, and younger workers coming into the labor force will need. But these are just the kinds of investments and jobs that institutional investors, including retirement plans, have been forcing companies to avoid or eliminate. Further, Wall Street is devoted almost entirely to helping wealthy people speculate with parasitic investments and is not equipped to provide the equity capital needed to make the productive investments.

Today, attention is being paid to problems on the credit and consumption sides of the economy, but regardless of when the recession formally ends, America's recovery and long range prosperity will be limited by problems on the equity and production sides. These problems will be harder to fix than the ones being considered now because they are more subtle; few people understand them; the fixes will require far more complex changes to the financial system; governments have reached their borrowing limits; and Wall Street will deny the problems and may delay action until it is too late to avoid another crisis.

But problems on Main Street, which Wall Street helped to create and many economists are missing, will not just go away and it is impossible to explain how the economy can regain its strength unless it is based on a strong Main Street.

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