How billionaires destroy democracy

Wealthy Wall Streeters have rigged the economy and the government against the people. Here's how they did it.

BY **LINDA MCQUAIG** AND **NEIL BROOKS**
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Kenneth Griffin, Philip Falcone, Jim Simons and John Paulson testify before a House Oversight and Government Reform Committee hearing on the regulation of hedge funds in 2008. (Credit: Reuters/Jonathan Ernst)

TOPICS: WALL STREET, EDITOR'S PICKS, FOX NEWS, KOCH BROTHERS

There are many words that could be used to describe Barack Obama, but one adjective decidedly doesn't fit: Aggressive. So it was more than passing strange when a prominent member of Wall Street — Stephen Schwarzman, chairman of the private equity giant Blackstone Group — compared actions by President Obama to one of the most notoriously aggressive acts by one of history's most aggressive villains. Speaking to the board of a nonprofit group, Schwarzman fiercely denounced initiatives by the Obama administration: "It's war. It's like when Hitler invaded Poland in 1939."

In the arena of political commentary, few things are considered more clearly below-the-belt than comparing an opponent to Hitler. So there was a small stir in August 2010 when it was reported that Schwarzman — whom Time magazine had included on its 100 most influential people list only three years earlier — had likened Obama to the Nazi strongman. Schwarzman acknowledged making the remark and then apologized for it, while reaffirming the sentiment behind it. But what was striking about the Hitler comment — besides its sheer viciousness and absurdity — was what had provoked it. Schwarzman wasn't complaining about undue military force, torture, or ethnic cleansing. He was likening the president to the most reviled man in history on the grounds that Obama was trying to close a tax loophole that allowed hedge fund and private equity managers (like Schwarzman) to pay tax at a rate that Warren Buffett famously notedwas lower than that paid by their secretaries.

In an era marked by gluttony and hubris, Steve Schwarzman has still managed to stand out.

His 60th birthday party in Manhattan in 2007 was so lavish — with live performances by Rod Stewart and Martin Short — it became Wall Street legend. Then there's Schwarzman's 35-room Park Avenue residence, his sprawling estate in Saint-Tropez, a spectacular spread in Jamaica, and his massive Palm Beach estate, where the executive chef says it typically costs about $3,000 a weekend to feed just Schwarzman and his wife.

Schwarzman is a major figure in private equity, part of the surging field of "alternative asset" financial institutions that, along with hedge and real estate funds, appeared on the horizon two decades ago and now control trillions of dollars in assets. While hedge funds are well-known for contributing to the subprime mortgage crash, private equity funds are notorious for taking over established firms with borrowed money and essentially pillaging them. The bought-out companies are typically saddled with increased debt from the takeover and forced to make massive dividend and fee payouts to the private equity managers and their investors, while employees are shedded and union contracts gutted. The companies are usually chopped up into smaller pieces and sold soon afterwards at inflated prices, creating another windfall for the private equity managers. By 2007, the Blackstone Group had taken control of more than 112 companies worth nearly $200 billion. In 2011, Schwarzman ranked 169th on Forbes' worldwide billionaire list, worth an estimated $5.9 billion.

Schwarzman may be rougher at the edges than most of the hedge fund and private equity crowd. But his outburst against Obama reminds us of the "war" he and others — by themselves or by proxies — have been engaged in to minimize their contribution to the public treasury. It's an all-too-familiar tale of how effective the rich are at getting their way, even when the battle is being played out in a very public arena where a small group of billionaires advancing their own self-interest would seem a very tough sell.

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Victor Fleischer didn't set out to be a 21st-century Robin Hood. His real aim was just to get tenure.

Fleischer joined the New York law firm Polk Davis in the late 1990s, working on the formations of private equity and venture capital funds. He was struck by the very low rates of tax paid by fund managers, even compared to the already low tax rates being paid by executives receiving corporate stock options. Fleischer wasn't discovering something new; the rules had been in place since 1954. Nor was he outraged or even particularly interested in the question of tax fairness. At the time, he was simply interested in the impact that the tax rules governing so-called "carried interest" might have on the law firm's clients.

The question stayed in Fleischer's mind after he left Polk Davis in 2001 and became a law professor specializing in taxation. Hoping to get a paper published to improve his chances of securing tenure, Fleischer put together his thoughts on the taxation of private equity funds. Now that he was no longer constrained by working for people in the private equity field, he started to pay attention to what seemed to him to be a "quirk" in the law that distorted tax principles while undermining distributive justice.

He identified the fact that managers of private equity, venture capital and hedge funds were claiming a significant part of their incomes as capital gains (taxed at 15 percent), rather than treating them as regular income (taxed at 35 percent). That substantial difference in rates was magnified by the enormity of the incomes in question. A private equity manager receiving, say, $600 million as a capital gain would pay $90 million in tax. If the same income were treated as income from salary, it would be taxed at 35 percent (and also be subject to a 2.9 percent payroll tax), bringing the private equity manager's tax bill to $227.4 million — almost $140 million more.

The ostensible purpose of the lower capital gains rate is to compensate investors for the risk they take in investing their capital. But private equity and fund managers aren't investing their own capital. They're investing other people's capital. They're simply money managers. By claiming capital gains treatment, they are passing off regular income as capital gains, simply to save themselves taxes.

The fund managers insist that their compensation is still very risky; while some deals may lead to huge profits, others prove disastrous. True. But risk is hardly confined to fund managers. And at lower income levels, the risks are far larger. Indeed, in the last 30 years, vast swaths of the economy could be designated as risky for those needing to earn a living. The sort of stable, lifelong jobs that were common a generation ago have been largely replaced by contract or part-time work, with little or no security. A layoff can mean the loss of the family home or health benefits, or even destitution — far more serious plights than anything likely to befall a hedge fund manager. (For that matter, no one ever seems to argue for special low tax rates for the real risk-takers among us — miners, oil-rig workers, acrobats, firemen, window washers working on tall buildings.)

The so-called “carried interest” loophole enjoyed by hedge fund and private equity managers raises the larger question of whether capital gains — even real ones — should ever be taxed at lower rates. On the face of things, the lower rate seems patently unfair. Why should someone earning income by investing their fortune be taxed at a substantially lower rate than those earning income from the sweat of their brows or from using skills they’ve spent years acquiring? The fairness argument has essentially been set aside, however, as business has relentlessly promoted the notion that such preferential treatment is necessary to coax those with capital to invest it. But do investors really need coaxing? Warren Buffett, one of the world’s savviest investors, doesn’t think so. “I have worked with investors for 60 years and I have yet to see anyone — not even when capital gains rates were 39.9 percent in 1976-77 — shy away from a sensible investment because of the tax rate on the potential gain,” Buffett argues.

Our business culture tends to portray investors as modern-day heroes who put their hard-earned capital into worthy high-risk ventures that lead to path-breaking discoveries that enrich the lives of all of us. Sadly, the vast majority of investments don’t fit into this category (and those that do qualify for additional tax incentives). Rather, as former mutual fund manager John C. Bogle notes, “most capital gains are made from gambling in the stock market.” So the ultimate function of the special low rate on capital gains is to save our wealthiest citizens billions of dollars a year on their winnings in the Wall Street casino.

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Fleischer’s paper found its way into the hands of congressional Democrats at a time when they were looking for fresh sources of revenue to pay for the expansion of the State Children’s Health Insurance Program and the Earned Income Tax Credit. The juxtaposition of high-flying hedge fund managers and children without health care seemed like a public relations nightmare for the Wall Street crowd.

Schwarzman himself helped put an unsavory face on the fund manager set with his plan to turn Blackstone into a publicly traded company in the spring of 2007. The plan would not only allow Schwarzman and other top Blackstone executives to continue to qualify for the low capital-gains rate as fund managers, but would also allow their new multi-billion-dollar publicly traded company to largely avoid paying corporate taxes. If Schwarzman won the approval of SEC regulators, he and Blackstone co-founder Peter Peterson would receive billions of dollars worth of stock, plus hundreds of millions in cash. And this would surely set a precedent, enticing other private equity funds, as well as investment banks — including giants like Goldman Sachs and Morgan Stanley — to reorganize themselves along similar lines, making the paying of corporate taxes almost optional for Wall Street institutions.

Schwarzman's move had pushed the issue of sweetheart taxation for private equity kings from law school reviews to the front pages of newspapers. A bill to stop Schwarzman — dubbed the Blackstone bill — quickly appeared in Congress.

Momentum seemed to be building against the Blackstone deal and more broadly for a bill, sponsored by Democratic congressman Sander Levin that would shut down the fund manager loophole completely. But Wall Street quickly organized a counterattack. Some of the largest private equity firms formed the Private Equity Council, and, within six months, the Council had retained four top lobby firms to handle the case. Labor and public interest groups lobbied from the other side, presenting a letter to Congress signed by more than a hundred organizations across the country urging that the loophole be closed. But private equity had resources that were probably 1,000 times greater, according to Steve Wamhoff, legislative director of the Washington-based group Citizens for Tax Justice.

No argument seemed too extreme or silly to advance in defense of maintaining the loophole. Lobbyists insisted, for instance, that the tax break was crucial in the fight against cancer, pointing to the fact that the loophole also applied to those running venture capital funds, which sometimes invest in high-risk start-up firms — including those developing products to fight cancer. Private equity was trying to make the case that showering tax breaks on all fund managers, some of whom might be investing their funds in firms involved in fighting cancer, was an effective way to subsidize the fight against cancer — rather than simply increasing direct subsidies to cancer researchers or start-up firms.

In the end, the weakness of the case for maintaining the loophole didn't matter. In three years of Congressional battles over the issue — with the Democrats mostly voting to shut down the loophole, and Republicans voting to keep it alive — the House passed a bill to shut it down three times. But Democrats finally abandoned attempts to overcome Republican obstacles in the Senate in June 2010. So, even with the Democrats holding the White House, the House and the Senate (including 60 seats for a while), "they were still incapable of closing the most indefensible loophole in existence," notes Wamhoff.

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In the run-up to the debt-ceiling crisis in the summer of 2011, the most indefensible loophole in existence was once again in the spotlight. Figures from the Congressional Budget Office showed that closing the loophole could save $21 billion over 10 years. That wouldn't eliminate the debt, of course, but given the scope of the debt problem, it seemed a lot of money to simply ignore. New York Times columnist Nicholas Kristof devoted a column to the tax break, awarding it the grand prize for the "Most Unconscionable Tax Loophole." The president himself zeroed in on it again. "How can we ask a student to pay more for college before we ask hedge fund managers to stop paying taxes at a lower rate than their secretaries?" Obama said in an address to Congress in July.

But the Tea Party crowd now becoming power players in the Republican Party was as resistant to compromise as Obama was prone to it. They blamed the mounting deficit entirely on Obama (even though George W. Bush had added $5.07 trillion to the debt, primarily due to his tax cuts and military spending, while Obama had added just $1.44 trillion, mostly fighting the recession). Spotting an opportunity to use the deficit to achieve deep spending cuts, hard-line Republicans refused to raise the debt ceiling without a long-term strategy for debt reduction, which they insisted be entirely achieved through spending cuts. In the final deal, signed into law just hours before the deadline for a Latin American–style default, the hijackers appeared to win, with $917 billion in deficit-reduction measures all to come from spending cuts (and another $1.5 trillion to be worked out by a bipartisan committee). The radical Republicans had turned the fairly routine business of raising the debt ceiling — something Republicans had agreed to 87 times since World War II — into a bloodbath of spending cuts.

An observer could easily conclude that all this simply shows how resistant Americans have become to tax increases. But in fact it shows no such thing. In the years leading up to the debt-ceiling showdown, Americans have repeatedly told pollsters that they support higher taxes*on the rich* as a way to reduce the deficit. A Washington Post-ABC News poll reported in July 2011, as the crisis reached a crescendo, found that 72 percent supported raising taxes on those earning more than $250,000 a year.

What the debt-ceiling fiasco really showed was how a band of Republican extremists had effectively taken the U.S. political system hostage and were moving to enact the Right's long-time fantasy of dismantling popular New Deal programs — particularly Social Security — which had been politically untouchable since the 1930s. Americans were told that these programs were simply no longer affordable — even though the country had grown considerably richer over the decades. In fact, what had changed was not the affordability of the programs but the intransigence of the nation's elite to paying taxes.

So while programs helping students, the elderly, and the poor were to be picked over by deficit-cutting politicians with surgical precision, private equity and hedge fund mangers were to be spared any increase in taxes. They could get back to work pillaging companies and destabilizing financial markets with full peace of mind, knowing they'd continue to enjoy a tax rate lower than the mechanics who service their private jets.

Indeed, only a month after the debt-ceiling crisis, Stephen Schwarzman was back on the offensive, no longer just defending the special tax break that saved him millions of dollars a year, but now insisting on the need for broad tax reform — *so that low-income people would pay more.*Schwarzman's concern was that many Americans manage to avoid paying income tax at all because their incomes are so low. His solution was a flat tax, so that everyone would pay some income tax. "If some people are left out and some people have special deals, it doesn't feel like the kind of situation where everyone's going to get on board," Schwarzman told CNBC." For Schwarzman, "special deals" aren't loopholes for billionaires but exemptions for those with low incomes — mostly the elderly, people with children, and the poor — who've been dubbed "lucky duckies" by the*Wall Street Journal* for their apparent tax-free status.

Having rebuffed Obama's invasion, the Wall Street crowd was now itching to launch a counter-invasion. No longer was the goal just to protect their own loopholes. They now sought to solve the deficit crisis, which they had greatly contributed to with their reckless financial speculation, by digging into the empty pockets of low-income Americans. It wasn't that the rich weren't paying enough tax; it was that others weren't paying enough. It was time to go after the lucky duckies. A new rallying cry could be heard rumbling from the boardrooms of Wall Street: *Make the Poor Pay!*

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Barely a month after Barack Obama had been sworn in as the 44th U.S. president, riding a wave of immense popular support with his "Yes, we can" rallying cry echoing around the country and the world, a voice seemed to appear from nowhere saying, "No, actually you can't." Ostensibly, it came first from Rick Santelli, a relatively obscure investment manager-turned-commentator on CNBC, who denounced Obama's plans to help struggling American homeowners as "promoting bad behavior." In a wide-ranging rant from the floor of the Chicago Mercantile Exchange on February 19, 2009, Santelli said, "We're thinking of having a Chicago Tea Party in July. All you capitalists that want to show up to Lake Michigan, I'm gonna start organizing." Within hours, a protest movement had swung into action on the Internet, talk radio, and cable TV, and rallies were scheduled across the country for the following week.

The apparently spontaneous outburst of disaffected Americans was greatly helped along by an organized and sophisticated campaign ultimately funded by two of America's richest men, Charles and David Koch.

In many ways, the emergence of the Tea Party as a potent force in American politics can be seen as the culmination of almost four decades of behind-the-scenes effort on the part of the billionaire brothers. The political views of the Koch brothers have always been on the extreme right, nurtured by their father, Fred Koch, a cofounder of the ultra-right-wing John Birch Society. Since inheriting his massive privately held oil fortune in the late 1960s, the brothers have been pouring untold millions of dollars into promoting libertarian causes. The probing of Ames and Levine, as well as a comprehensive, investigative piece by Jane Mayer in the New Yorker in August 2010, have shown that the brothers established a vast network of ultra-conservative political organizations, advocacy groups, publications, and think tanks. Included in this network is the high-profile Cato Institute, which has aggressively pushed for an end to Social Security, and the Mercatus Center, located at George Washington University, which has been a leading advocate of environmental deregulation and inaction on climate change.

The brothers have mostly stayed out of politics directly (apart from David Koch's stint as the vice presidential candidate for the Libertarian Party in 1980, positioned to the right of Ronald Reagan). Perhaps the Kochs sensed how politically toxic a couple of billionaires could be to a movement whose central aim has been slashing taxes on the rich and dismantling programs, like Social Security, that keep millions of Americans out of poverty.

In fact, the Kochs were really just one — although a leading one — of the ultra-rich U.S. families that in the 1970s turned their attention and directed their wealth to the task of pushing American politics sharply to the right and putting in place policies that more clearly favored their own interests.

The business elite is and always has been the most powerful force in U.S. politics, by virtue of its dominant role in the economy. But what is striking — and perhaps inspiring to revisit — is the extent to which the power of business was somewhat curtailed in the 1930–1970 period, and the extent to which this allowed policies favoring other members of society to flourish.

But by the early 1970s, with postwar growth starting to stall, business had an opening. It also had a growing sense that it was losing ground to a broader anti-business movement that came out of the mass student protests over U.S. involvement in Vietnam. The movement's ostensible leader, Ralph Nader, was attracting widespread support and sympathetic media coverage for this freewheeling campaign against "corporate power." The threat felt by business leaders was captured well in an eight-page memorandum written in 1971 for the U.S. Chamber of Commerce by Lewis Powell, a prominent Virginia, attorney who served on a number of corporate boards (and later on the Supreme Court). The memo, expressed a feeling of being under siege. It amounted to a manifesto warning business that "the American economic system is under broad attack" and the assault was gaining influence "from the college campus, the pulpit, the media, the intellectual community . . . and from politicians." Powell echoed Goldwater's earlier condemnation of "scared-e-cat" businessmen, urging them to "stop suffering in impotent silence, and launch a counter-attack."

Powell laid out a comprehensive plan that bears an uncanny resemblance to what actually happened. He argued that business largely owned, funded, or had influence over the key media, religious, and academic institutions in society, and should use its leverage to counter what he perceived as the liberal, anti-business bias of these institutions. He advocated explicit business intervention in the political sphere, where he said the American businessman had become "truly the forgotten man." This had to be countered with concrete steps — expanding the "role of lobbyist for the business point of view" — in order to regain political clout with governments. It was time, wrote Powell, for business to learn that "political power is necessary; it must be used aggressively and with determination — without embarrassment and without reluctance which has been so characteristic of American business."

Powell's manifesto reverberated powerfully within business circles. Along with the Koch brothers, a number of America's biggest corporate dynasties came forward to inject massive funds into the cause of pushing the country sharply to the right. The Olin family, owner of a giant chemical and munitions business, provided tens of millions of dollars to think tanks, organizations, and programs at major universities aimed at inculcating right-wing ideas and policy solutions. Huge financial support for libertarian and conservative causes (and later the attempt to impeach Bill Clinton) also came from Richard Mellon Scaife, heir to the massive Mellon banking, aluminum, and oil fortune. Joseph Coors, who had inherited the brewery fortune, described how he was "stirred up" by reading the Powell memo and wondered why businessmen were "ignoring a crisis."

Freshly stirred by Powell's call to arms, Coors became a key figure in establishing the Heritage Foundation, which was to become an influential promoter of radical pro-capitalist ideas as well as "the Judaeo-Christian moral order." The foundation quickly attracted major corporate funding from Dow Chemical, General Motors, Pfizer Mobil, Chase, and the Manhattan Bank. Du Pont CEO Charles McCoy became one of the instigators of the Business Roundtable, an exclusive group of CEOs of leading U.S. companies, who planned to use their economic clout to gain access to top government and congressional leaders.

The war chest of funds from wealthy families and corporations provided the seed money for a huge new infrastructure of organizations, think tanks, publications, and "astro-turf" campaigns funded by the wealthy but designed to appear as grass-roots movements. With this massive effort to reshape the debate and politics of America, the wealthy elite was investing in a deliberate long-term strategy — exactly what Powell had called for — realizing that institutions shaped by liberal values wouldn't change over night, but could be completely overhauled over time through determined push-back from business. The media, owned by business interests, quickly became a helpful collaborator, and the buzzwords of free-market ideology were soon dominating the airwaves. The rightward drift accelerated after media mogul Rupert Murdoch hired former Republican strategist Roger Ailes to launch Fox News in 1996 with an aggressive conservative message that pushed the media concept of balanced coverage ever farther to the right.

The impact on the Republican Party has been the most profound, with conservative money ensuring that moderates in the style of Dwight Eisenhower — or even George H. W. Bush — are increasingly blocked from winning their party's nominations. The impact of conservative money on the Democratic Party has also been immense. With increasingly expensive political campaigns in the TV age, business gained a huge advantage with cash-hungry Democratic candidates, particularly after labor's economic clout and financial contributions diminished. As labor faded, the well-financed voices of business grew louder and more persistent, aggressive, and ubiquitous. Democrats became the new scared-e-cats, retreating in lockstep as the conservative juggernaut advanced, putting up scant resistance as the goalposts were moved ever farther to the right. The Democrats largely abandoned support for important labor policies, allowing the minimum wage to languish, supporting trade deals that encouraged privatization and favored corporate interests, and even emerging as the leading proponents of financial deregulation in the 1990s. This brought in huge campaign support from the financial industry, realigning the party with Wall Street, particularly under the influence of powerful Democratic senators Charles Schumer and Joseph Lieberman.

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The campaign to roll back the postwar egalitarian advances, starting in the 1970s, gained momentum in the following decades as the rich got vastly richer and invested heavily in a sophisticated political infrastructure to advance their cause. Their political victories not only enriched themselves further but weakened other segments of society, creating economic insecurity for millions of Americans. That insecurity left ordinary Americans frightened, short of resources, and no longer inclined to trust and rely on unions, which seemed increasingly impotent in the face of rising business wealth.

The 2008 financial crash and its brutal aftermath has raised the possibility that the pendulum might swing back, once again diminishing the wealth and power of the elite. This hasn't happened yet — although the Occupy Wall Street demonstrations in the fall of 2011 point to a building storm.

So far, however, the privileged elite have mostly managed to protect and even enhance their financial position, with the Wall Street crowd using its clout to win a massive $4.7 trillion bailout. The elite have also managed to derail attempts to raise their taxes. The very rich seem poised to dismantle programs that are vital to the well-being of millions of ordinary Americans and that for decades seemed politically untouchable.

Mark Hanna may well have identified a crude truth about American politics when he said "There are two things that are important in politics. The first is money and I can't remember what the second is." Perhaps the second thing, which the Republican strategist so casually forgot, is that it matters how widely money is distributed. We therefore offer up a corollary to Hanna's rule: When money is distributed more equally in society, ordinary citizens speak with louder voices, making meaningful democracy possible.

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