The Curse of Stock Buybacks[1]

For the past three decades, the overriding priority of American corporations has been paying their shareholders. That's just what they've done with their tax cut.

by William Lazonick

In slashing the corporate tax rate from 35 percent to 21 percent, the Republicans' Tax Act is supposed to provide companies with extra after-tax profits that, through productive investments, will create jobs for Americans. Instead of helping to rebuild the vanishing middle class, however, the tax savings will further enrich shareholders through stock buybacks and cash dividends. With share prices inflated by stock buybacks, the richest U.S. households will extract even more value from the economy, making America's rampantly unequal income distribution even worse.

Even before the adoption of the Tax Act, it was no secret that corporations would use the corporate tax breaks to increase distributions to shareholders. At the Wall Street Journal CEO Council in November 2017, a moderator asked the roomful of top executives: "If the tax reform bill goes through, do you plan to increase your company's capital investment, show of hands?" Only a few CEOs half-raised their hands, prompting Trump's then–chief economic adviser, Gary Cohn, a featured speaker at the event, to ask: "Why aren't the other hands up?" As evidenced in later interviews of some of the CEOs, they already knew that the tax breaks would end up as buybacks and dividends.

It should come as no surprise that corporate executives' top priority for the tax cuts has been to increase distributions to shareholders, for three reasons:

First, senior executives' stock-based pay provides them with strong incentives to distribute corporate cash to shareholders. Annual mean CEO remuneration at the 475 Standard & Poor's 500 companies that remained on the index from 2007 through 2016 ranged from $9.4 million in 2009, when the stock market was in the dumps, to $20.1 million in 2015, when the stock market was booming. Most of this total remuneration—ranging from 53 percent in 2009 to 77 percent in 2015—came in the form of realized gains from stock-based pay (stock options and stock awards).

Second, since the 1980s, corporate executives have proclaimed that their only corporate responsibility is to "create value" for shareholders. Most recently, over the decade of 2007 to 2016, stock repurchases by 461 S&P 500 companies totaled $4 trillion, equal to 54 percent of profits; in addition, these companies declared $2.9 trillion in dividends, which came to 39 percent of profits. Indeed, in the name of "maximizing shareholder value," corporate executives are often willing to take on corporate debt, terminate employees, reduce wages, sell assets, and diminish cash reserves to do buybacks.

Third,since the mid-2000s, hedge fund activists, with billions of dollars of assets under management, have increasingly pressured corporations to do buybacks. Armed with their huge "war chests," these new-style corporate predators use a corrupt proxy-voting system, "wolf pack" hook-ups with other hedge funds, and once-illegal engagement with management to compel corporations to hand over profits that the hedge funds did nothing to create.

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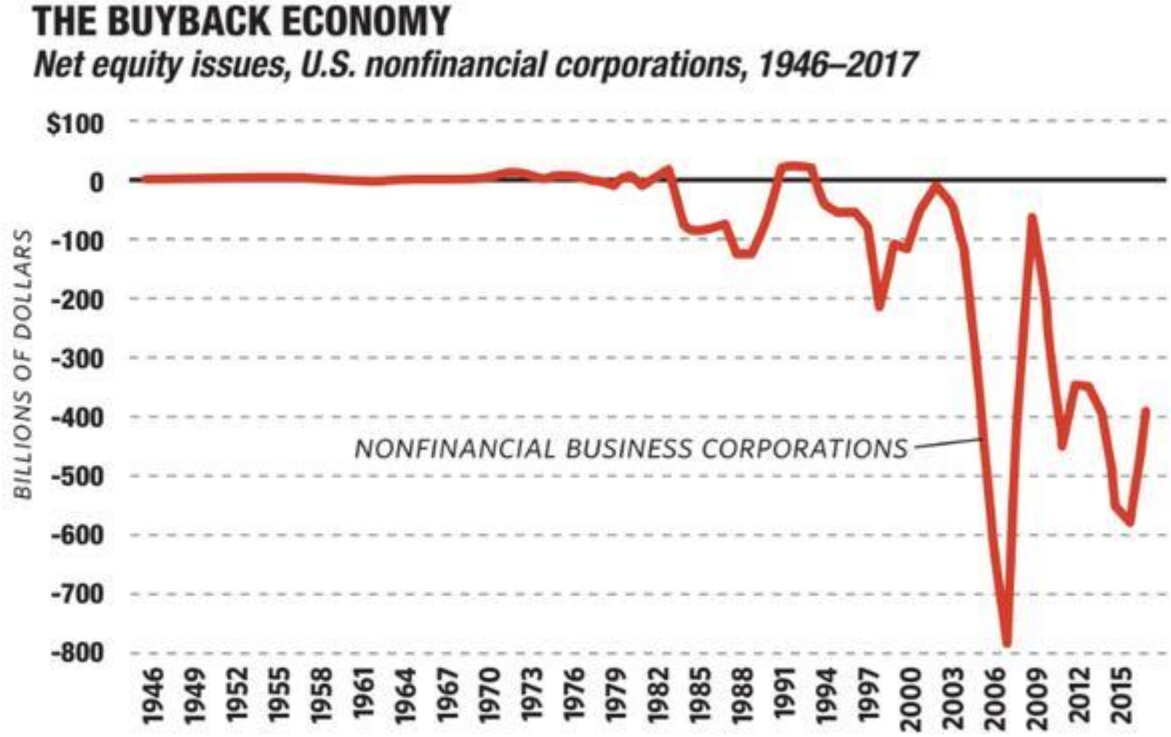
[1] *The American Prospect*, June 25, 2018

In short, the expectation that corporations will use the Republican tax cuts to hire more employees and invest in productive capabilities flies in the face of the financialized business model that a large and growing number of major U.S. corporations have adopted over the past 30 years.

REPURCHASES DONE ON THE open market, which constitute the vast majority of all buybacks, are nothing but manipulation of a company's stock price. That should be illegal, but it is obviously not. Companies are permitted to engage in this practice because in 1982, the Securities and Exchange Commission (SEC) adopted Rule 10b-18, which permits a company to do buybacks that can amount to hundreds of millions of dollars per day—trading day after trading day—without fear of being charged with stock-price manipulation. SEC Rule 10b-18, which remains in force, is a license to loot the U.S. business corporation.

Stock buybacks are massive—so much so that it is not at all sarcastic to call today's U.S. corporate economy a "buyback economy." The top chart at right shows net equity issues (new stock issues minus stock taken off the market through stock repurchases and mergers and acquisitions) of U.S. nonfinancial corporations from 1946 through 2017. Over the decade of 2008 to 2017, net equity issues of nonfinancial corporations averaged negative $371 billion per year. Net equity issues were negative $577 billion in 2016 and negative $379 billion in 2017.



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL RESERVE STATISTICAL RELEASE Z.1, TABLE F-223: CORPORATE EQUITIES, JUNE 7, 2018

As can be seen in the first chart, net equity issues first became significantly negative in 1984, following the SEC's adoption of Rule 10b-18. Using the numbers in the chart, the first data column of the table shows the amounts of net equity issues by nonfinancial corporations, decade by decade, from 1946 to 2015, in 2015 dollars. For the first three decades after World War II, net equity issues were moderately positive in the corporate economy as a whole. In the following decades, however, net equity issues became increasingly negative (even after adjusting for inflation). As a gauge of their growing importance in the economy, the second data column of the table shows net equity issues as a proportion of GDP.

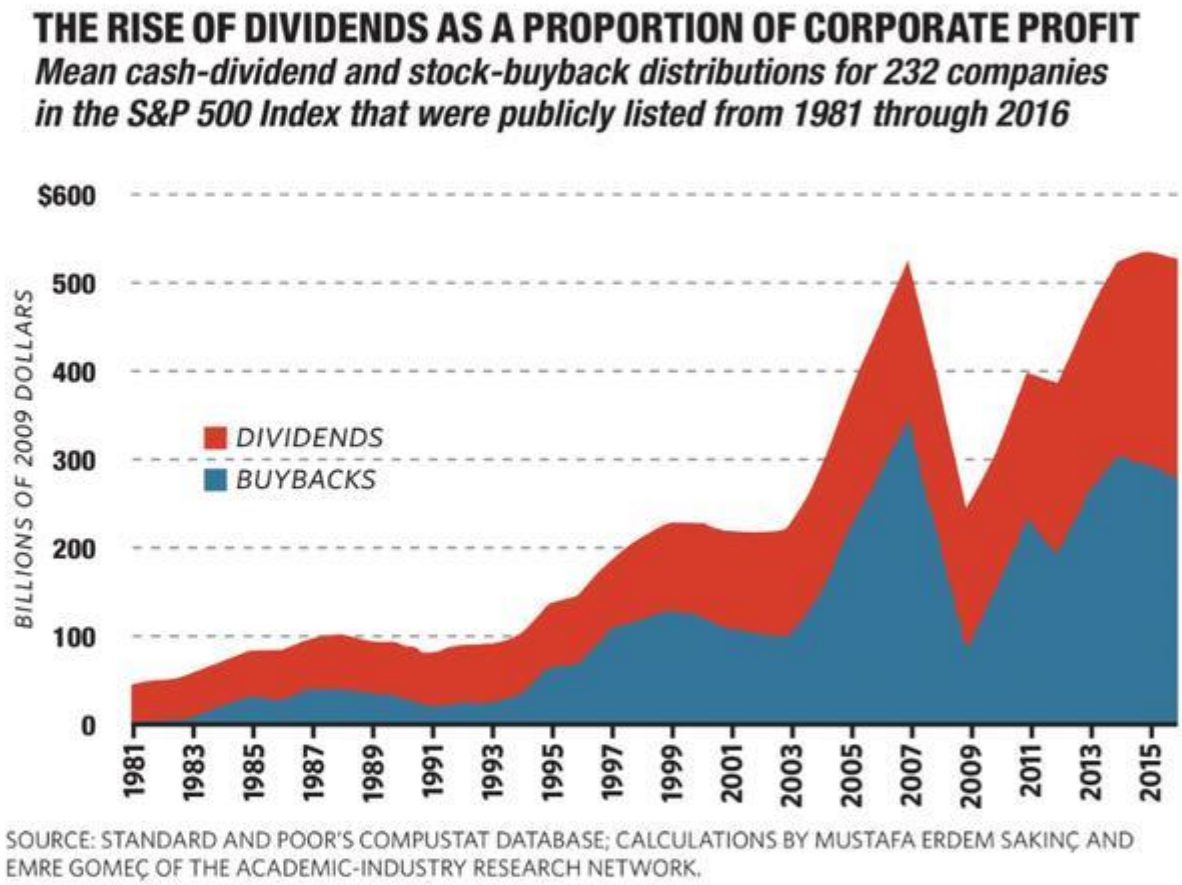
Over the past three decades, in aggregate, dividends have tended to increase as a proportion of corporate profits. Yet in 1997, buybacks first surpassed dividends in the U.S. corporate economy and, even with dividends increasing, have far exceeded them in recent stock-market booms. The second chart shows 36 years of dividends and buybacks for the 232 companies in the S&P 500 Index in January 2017 that were publicly listed from 1981 through 2016.

Years	Non Equity Issues US Non-financial Corps, in 2015 Billions	Net Equity Issues as % of GDP
1946–1955	$143.2	0.56%
1956–1965	$110.9	0.30%
1966–1975	$316.0	0.58%
1976–1985	–$290.9	–0.40%
1986–1995	–$1,002.5	–1.00%
1996–2005	–$1,524.4	–1.09%
2006–2015	–$4,466.6	–2.65%

SOURCES: NET EQUITY ISSUES DATA ARE THE SAME SOURCE AS IN THE TOP CHART, ADJUSTED TO 2015 US DOLLARS, USING THE CONSUMER PRICE INDEX IN COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT, JANUARY 2017, TABLE B-10.

Up to the beginning of the 1980s, buybacks were minimal, and from 1981 through 1983 buybacks for these 232 companies absorbed only 4 percent of net income, with dividends representing 49 percent. The buyback proportion of net income increased to 17 percent in 1984, 31 percent in 1985, and 27 percent in 1986, while the dividend proportions were 45 percent, 52 percent, and 57 percent. Thereafter, by ten-year periods, the buyback proportions of net income increased from 27 percent in 1987–1996 to 45 percent in 1997–2006 and 50 percent in 2007–2016. Even though dividend payout ratios were lower in 1997–2006 and 2007–2016 than in 1987–1996, total payout ratios to shareholders rose from 76 percent to 84 percent to 92 percent over these three periods. And not included among these companies are some of the largest “New Economy” repurchasers publicly listed after 1981, including three of the top ten repurchasers for the decade of 2007 to 2016: Microsoft ($120 billion in buybacks, equal to 68 percent of net income), Cisco ($63 billion; 78 percent), and Oracle ($57 billion; 67 percent).

Retained earnings—profits not distributed to shareholders—have always been the financial foundation for business investment in innovation and sustained employment. In a “retain and reinvest” corporate resource-allocation regime, retentions can fund investment in plant and equipment, research and development, and, of critical importance, training and retaining employees. If dividends alone are too high, investments in the company's productive capabilities will suffer. The addition of buybacks to dividends over the past three decades reflects a failure of corporate executives to develop strategies for investing in the productive capabilities of the companies over which they exercise control. The results have been stagnant wages, insecure employment, and worker terminations, as corporate resource allocation has increasingly transitioned from "retain and reinvest" to "downsize and distribute."



Dividends are the traditional and legitimate way for a publicly listed corporation to provide income to shareholders. Dividends provide shareholders with an income for (as the name says) holding shares. Moreover, if the firm retains enough of its profits to finance further investment in the company's productive capabilities, there is the possibility (although by no means the certainty) that it will generate competitive products that, through innovation, will help lift its future stock price and the value of the shares held.

In contrast, by creating demand for the company's stock that provides an immediate manipulative boost to its stock price, buybacks reward those shareholders who are best positioned to sell their shares. Under SEC Rule 10b-18, companies do not publicly disclose the precise days on which they are doing open-market repurchases, creating opportunities for insider gains by corporate executives, investment bankers, and hedge fund managers who can access this type of information to time their stock sales to take advantage of buyback activity. Buybacks also automatically increase earnings per share (EPS) by decreasing the number of shares outstanding. The rise in EPS tends to stimulate additional demand for a company's stock, thus creating further opportunities for stock-market traders to sell their shares at a gain even in the absence of increased corporate revenues or profits.

Over the past three decades, U.S. stock markets have enabled the extraction of trillions of dollars from business corporations in the form of stock buybacks. Of course, some companies do raise funds on the stock market, particularly when they are doing initial public offerings (IPOs). But these amounts tend to be relatively small, swamped overall by stock repurchases.

A RETAIN-AND-REINVEST corporate resource-allocation regime was central to the 20th-century ascendance of the United States to global industrial leadership. Through retain and reinvest, a relatively small number of very successful business enterprises in a range of critical industries grew to employ tens, or in some cases hundreds, of thousands of people. Companies retained corporate profits and reinvested them in productive capabilities. First and foremost were the collective and cumulative learning processes essential for generating high-quality, low-cost products. With these companies dominating the industries in which they operated, in the years leading up to the 1980s the norm of a career with one company prevailed. Shareholders had an interest in retain and reinvest, given a steady stream of dividend income and the prospect of higher future stock prices based on innovative products.

Since the 1980s, a downsize-and-distribute resource-allocation regime has increasingly replaced retain and reinvest. Under downsize and distribute, the corporation lays off experienced, and often more expensive, workers, while pressing down the wages and benefits of those who remain, and distributes corporate cash in the forms of dividends and buybacks to shareholders. Since the beginning of the 1980s, the move from retain and reinvest to downsize and distribute has been precipitated by three major structural changes in employment relations in U.S. industrial corporations, all of which have eliminated existing middle-class jobs in the United States. From the early 1980s, permanent plant closings wiped out the jobs of high school–educated blue-collar workers, most of whom had been well-paid union members. From the early 1990s, a growing number of U.S. corporations deliberately and explicitly put an end to “a career with one company” as an employment norm, thus jeopardizing the job security of middle-aged white-collar workers, many if not most of them college-educated. From the early 2000s, globalization of employment accelerated, with the movement of formerly U.S.-based jobs offshore to lower-wage nations, leaving all members of the U.S. labor force vulnerable to displacement, irrespective of their educational credentials and work experience.

For the most part, these changes in employment relations began as corporate responses to changes in industrial conditions related to technology, markets, and competition. But instead of repositioning their organizations to generate innovative products, U.S. corporations often continued these changes in employment relations in order to cut current costs simply to increase the amount of profits that could be distributed to shareholders. Trillions of dollars that these companies could have spent on investment in productive capabilities over the past three decades have instead been used to buy back stock for the purpose of boosting stock prices.

The dramatic transformation of U.S. corporate resource allocation from retain and reinvest to downsize and distribute that has taken place over the past four decades was not preordained. Rather, the rise to dominance of the corporate-governance ideology of “maximizing shareholder value” (MSV) imposed the proclivity to downsize and distribute on the American people. Following tenets of MSV, business executives have enriched themselves, as well as other financial interests, by extracting value that the companies that they control created in the past, rather than investing corporate profits in productive capabilities that could create value in the future.

Proponents of MSV contend that by “unlocking” value for shareholders, companies reallocate resources that improve the performance of the company and the economy as a whole. These MSV claims, however, have their roots in two misconceptions of the role of public shareholders in the U.S. business corporation. The most fundamental error is the flawed assumption that public shareholders invest in the productive assets of the corporation. As a general rule, they do not.

Rather, they simply allocate their savings to purchase shares outstanding on the stock market. They are willing to buy and hold shares because the liquidity of the stock market enables them to sell them whenever they choose to do so.

Public shareholders are portfolio investors, not direct investors. The generation of innovative products requires direct investment in productive capabilities. When, as in the case of a start-up, financiers make equity investments in the absence of a liquid market for the company's shares, they are direct investors who face the risk that the firm will not be able to generate a competitive product that can yield a financial return. But so, too, and to a far greater extent as the firm grows to dominance, are taxpaying households and workers, and hence they—and not just, or even primarily, shareholders—have an economic claim on the distribution of profits.

Taxpayers also have claims on the distribution of profits. Households as taxpayers regularly fund government agencies that make investments in productive resources and provide financial subsidies that benefit companies. Yet taxpayers do not have a guaranteed return to this funding. The National Institutes of Health (NIH) is an important example (and only one of many). In 2017, the budget of the National Institutes was $33.1 billion, part of a total NIH investment in life-sciences research spanning 1938 through 2017 that adds up to just over $1 trillion in 2017 dollars. Businesses that make use of NIH-funded research benefit from the public knowledge that it generates. Through the tax system, households as taxpayers can extract a return from profitable corporations that have gained from government spending. But taxpaying households run the risk that predatory value extractors—financial interests that "take" far more than they "make"—may convince government policymakers that businesses such as pharmaceutical companies need tax cuts or financial subsidies if they are to have the resources to invest in productive capabilities.

Workers regularly make productive contributions to the companies for which they work through the exercise of their skill and effort, with the expectation that they will be rewarded through ongoing employment at the company, with increased job security, wages, and benefits. Yet these expected rewards through continued employment are not guaranteed. Indeed, under the downsize-and-distribute resource-allocation regime legitimized by MSV ideology, employment security and its expected benefits have been undermined. Workers also confront the risk that the institutional environment that conforms to MSV ideology will empower corporate executives to lay off some workers and cut the wages of others for the sake of extracting value for shareholders that those very same workers helped to create.

MSV has had a profound influence on the real world of corporate resource allocation, and hence on the performance of the economy. A key to the implementation of MSV was the capture in 1981 of the SEC by free-market Chicago economists through Ronald Reagan's election as president. Reagan appointed E.F. Hutton executive John Shad as chair of the SEC, putting the agency that was supposed to eliminate fraud and manipulation from the nation's financial markets under the leadership of a Wall Street banker, who staffed the agency with Chicago-school economists.

It was under Shad's rule that on November 17, 1982, the SEC promulgated Rule 10b-18, giving companies that do open-market repurchases "safe harbor" protection against manipulation charges. Under the safe harbor, the company will not be charged with manipulation if, while also complying with some other stipulations, the volume of buybacks done on any single day is no more than 25 percent of the previous four weeks' average daily trading volume. The safe harbor means that under Rule 10b-18, the company is not presumed to be engaged in manipulation of its stock price even if its repurchases exceed the 25 percent daily limit.

Apart from one very informative Wall Street Journal article, the adoption of Rule 10b-18 went unnoticed by the media and the public. Yet, alongside the much more visible cuts in personal tax rates for the rich, Rule 10b-18 was profoundly important to Reagan's “supply side” revolution. Over the subsequent decades, stock buybacks have channeled the productivity gains of U.S. business into the hands of the richest households, while the persistent gushers of corporate cash have played a major role in the rise of the financial sector over the once-dominant manufacturing sector.

As buybacks have now been an axiom of U.S. corporate conduct for the past three decades, the selling point that Republicans invoked to promote their 2017 corporate tax cut—that it would create investment and jobs—was never even remotely plausible.

Rolling back the tax cut, then, should be only the first step in diminishing the squandering of the nation's economic resources. It must be accompanied by scrapping the rule that has enabled buybacks to flourish.

There is a straightforward and practical way to accomplish this second objective: Congress should ban corporations from doing stock buybacks. The justification for Rule 10b-18 has never been debated, nor have its provisions been legislated, by Congress.

That may, however, finally be changing. A number of Democratic senators, including Tammy Baldwin, Elizabeth Warren, Bernie Sanders, Brian Schatz, Charles Schumer, Chris Van Hollen, Cory Booker, and Sherrod Brown, have voiced criticisms of buybacks, as has former Vice President Joseph Biden.

The most persistent challenge to this corrupt practice has come from Wisconsin's Baldwin, who has recently challenged the prescription drug lobby group PhRMA to reconcile its claim that the pharmaceutical companies need high drug prices to fund R&D with the fact that the major companies spend virtually all their profits on buybacks and dividends. Baldwin also wrote letters to the two most recent nominees for SEC commissioner—Democrat Robert Jackson Jr. and Republican Hester Peirce—demanding that they make clear their positions on buybacks.

And most importantly, on March 22, Baldwin introduced legislation known as the Reward Work Act, which would rescind Rule 10b-18 and, for the sake of retain and reinvest, mandate that all U.S. publicly listed business corporations have one-third of board members be representatives of workers. Rolling back the 2017 corporate tax cut is imperative. In addition, a ban on stock buybacks would be a giant step in resurrecting corporate employment as a foundation for a prosperous and expanding middle class.