STOCK BUYBACKS: DRIVING A HIGH-PROFIT, LOW-WAGE ECONOMY

REPORT BY **LENORE PALLADINO** | MARCH 2018

Stock buybacks by America's largest public companies have exploded—one financial services firm recently predicted that buybacks would increase by as much as 50 percent this year to $800 billion following passage of the Tax Cuts and Jobs Act—and, over the past 10 years, now total more than half of how companies utilize all corporate profits (Linnane 2018). The increased attention to stock buybacks as a result of this surge provides an opportunity to consider not only the short-term effects of the tax law, but also the ways in which the rise of stock buybacks, now and over the last 30 years, is both a symptom and a cause of the high-profit, low-wage corporate sector we see today. This issue brief describes what stock buybacks are; outlines the problems they cause for companies, workers, capital markets, and broad-based economic growth; and proposes policy solutions to address them.

WHAT ARE STOCK BUYBACKS?

Open-market share repurchases, often known informally as "stock buybacks," occur when companies purchase back their own stock from shareholders on the open market. When a share of stock is bought back, the company reabsorbs that portion of its ownership that was previously distributed among other investors.[1] This reduces the amount of outstanding shares in the market, resulting in an increase in the price per share. The logic is that of supply and demand: when there are fewer supplies available to purchase, then an upward demand will increase share prices.

In essence, then, stock buybacks raise share prices *artificially*. The value of the stock goes up as a result of a stock buyback, but without making the kinds of changes that would improve the actual value of the company—through more efficient production, new products, or better customer experience. As the following sections argue, this has consequences for the market, for investors, for workers, and for society overall.

[1] There are other instances when companies purchase their own stock, e.g. through tender offers, but these purchases do not happen on the open market and are different from the open-market stock buyback discussed here.

Proponents of stock buybacks argue that they are an efficient mechanism for companies to deal with extra cash for which they do not have a productive use. Freeing up money that cannot be put to productive uses, the argument goes, allows shareholders to instead invest that money in companies that can, thus making for a more economically efficient allocation of capital (Cochrane 2018). This argument is based on the faulty premise that only companies without opportunities for productive investments are engaging in stock buybacks; in fact, money is flowing out of firms at a much higher rate than money is returning to them—according to one estimate, $6 is withdrawn for every $1 that is invested (Mason 2015b). Stock buybacks, then, are not an efficient use of otherwise unused capital; rather, they are rendering firms unable to engage in productive investments because there is no capital leftover for other investment opportunities or for other corporate stakeholders.

STOCK BUYBACKS: BEYOND THE FAILURE OF THE TAX LAW

The dramatic rise in stock buybacks as a result of the windfall from the Tax Cut and Jobs Act has led to substantial new attention to buybacks and their impact on companies and markets. Many commentators have appropriately cited the growth of stock buybacks as evidence that the law's corporate tax cuts did not have the substantial benefit for workers that proponents claimed (Phillips 2018). While true, there are a number of reasons to be concerned about what the rise in stock buybacks tells us about our economy beyond this near-term policy and political debate.

Stock buybacks are both a symptom and a cause of the high-profit, low-wage corporate sector we see today. They are the tip of the spear of the larger trend in which value is extracted from corporations by shareholders, rather than creating a virtuous loop of continuous productivity growth, in which multiple stakeholders—workers, smaller businesses along the supply chain, the public—benefit. This trend began in the 1980s, when corporations began shifting away from the idea that their primary purpose was to meet the demands of all their stakeholders, to a narrower conception that their primary purpose is to maximize value exclusively for their shareholders—a shift that was facilitated by a series of changes in the laws that governed corporations.

As the scale of stock buybacks grows—the section below describes just how common a feature stock buybacks have become—it has become increasingly clear that there is something deeply flawed with the way corporations are currently run, as well as the rules that incentivize certain corporate behaviors, particularly when compared to the model of corporate behavior we need companies to follow for a healthy and well-functioning economy.

The story of stock buybacks is not a story of corporate malfeasance. Rather, it's a story of misaligned incentives, where the rules that structure our market-based economy—and in this case, how corporate executives are compensated—are failing to result in the kinds of corporate governance we need to generate a strong and thriving middle-class whose purchasing power can drive our economy forward.

The following sections describe the rising prevalence and recent explosion of stock buybacks, explain why this rise is concerning, and offer policy solutions that address the challenges they pose.

STOCK BUYBACKS: HOW PREVALENT ARE THEY?

Stock buybacks are not a minor feature of corporate behavior. Rather, the last three decades have seen a consistent and significant rise in the practice of buying back stock on the open market. Companies now buy back more stock (through open-market buybacks and share retirement due to mergers and acquisitions) than they issue; in 2016, net equity issuance was minus five hundred eighty billion dollars (-$580 billion) (Federal Reserve 2017). Over the last decade-and-a-half, firms have sent **94 percent** of corporate profits out to shareholders, in the form of buybacks, as well as dividends, leaving companies to argue that there is little available for employee compensation or investment (Lazonick 2014). Specifically, William Lazonick (2014) examines the corporate practices of 449 companies that were listed on the S&P 500 continuously from 2003-2012. He found that companies used 54 percent of their earnings to buy back their own stock and spent an additional 37 percent on dividends of their earnings.

Now, the Tax Cuts and Jobs Act has resulted in a drastic increase in the usage of stock buybacks, far beyond even these 20-year upward trends. Since passage of the tax law, stock buybacks have already doubled in the beginning of 2018, as compared to the same period in 2017 (Domm 2018). Various estimates have shown that more than **$200 billion** of new stock buyback programs have been authorized after the tax bill was passed, as outlined in a special report from the Democratic Caucus of the U.S. Senate (2018). An analysis by Just Capital (2018) found that just 6 percent of the tax windfall is going to employees, while 60 percent is going to shareholders. A separate analysis by William Lazonick, Emre Gomec, and Rick Wartzman (2018) found that, so far, companies have announced share buyback programs that are **30 times** as valuable as the announcements of increased employee compensation.

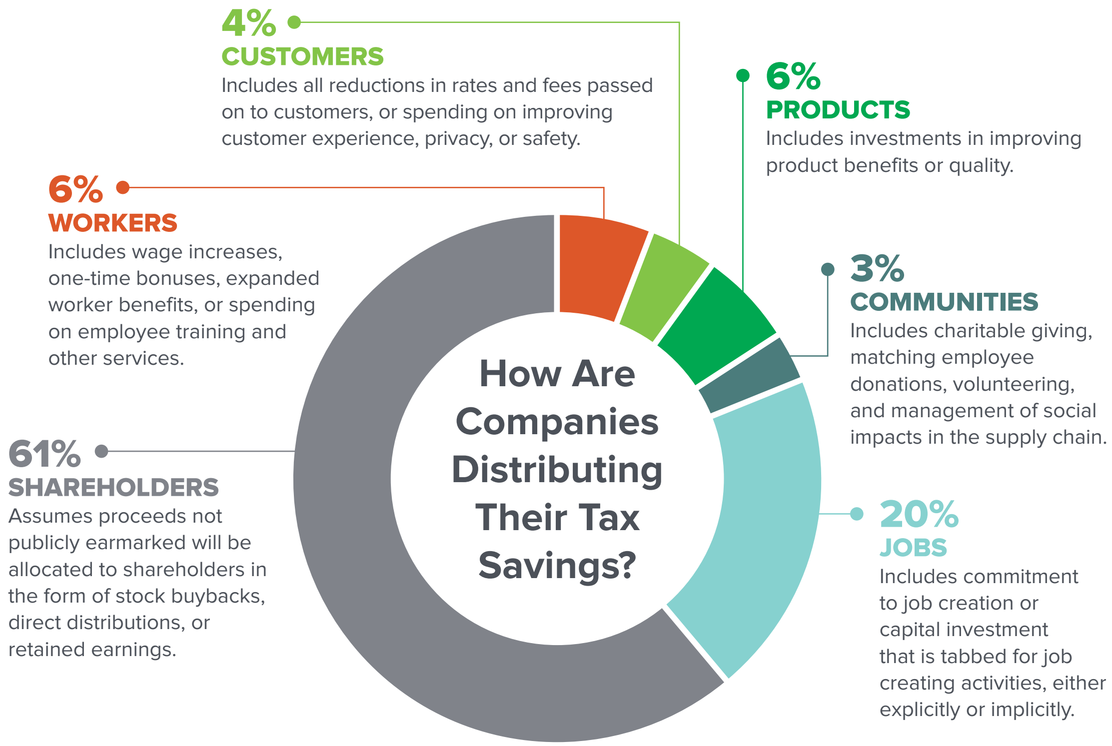

FIGURE 1 Chart reproduced from the "Rankings on Corporate Tax Reform" report. Latest version updated by Just Capital on March 5, 2018. Source: Just Capital (2018).

STOCK BUYBACKS: A CHANGE IN THE RULES, AND CORPORATE EXPECTATIONS, HAVE CAUSED THEIR DRAMATIC INCREASE

The rise of stock buybacks—and with it, the dramatic rise in the exodus of corporate profits out to shareholders at the expense of workers and other corporate stakeholders—can be traced to a 1982 rule issued by the Securities and Exchange Commission (SEC), known as the "safe harbor" rule. The Securities and Exchange Act imposes civil and criminal penalties for engaging in activities that manipulate the markets. In 1982, under the leadership of Ronald Reagan's SEC chair and the first Wall Street executive to lead the agency since its founding, the SEC adopted a rule that shielded a company buying back its own stock from liability as long as doing so met certain conditions about the timing and volume of the purchases.[2] This rule ignored the simple fact that the basic purpose of buying back one's own stock on the open market was, in most instances, to artificially inflate stock prices.

[2] Sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") prohibit such fraudulent and manipulative practices in connection with an issuer's (or "affiliated purchaser's") purchase of the issuer's own securities. Rule 10b-18 allowed for companies to put in place stock buyback programs and carry them out after approval by the board of directors, and sets up a non-exclusive safe harbor against allegations of market manipulation under Sections 9(a)(2), 10(b), and Rule 10b-5 solely by reason of the manner, timing, price, and volume of the repurchases.

THE PROBLEM WITH STOCK BUYBACKS

In addition to the ways the dramatic increase in stock buybacks points to a larger story about the problems with our economy, there are several reasons why stock buybacks themselves are troubling. It is useful to disaggregate these reasons to understand why and how best to regulate them.

Stock Buybacks and Market Manipulation

First, and most simply, stock buybacks may be manipulating stock prices because the very nature of buying back stock means that the remaining shares rise in value. Stock buybacks have become a favorite corporate practice because they are a straightforward and fast mechanism to raise share prices and boost earnings per share (EPS). The SEC's safe harbor rule encourages firms to limit their stock buybacks within its timing and volume conditions, so that, in theory, buybacks would not have a manipulative effect on the market. But the main effect of buybacks in the short term is to reduce the number of shares available on the open market for trading, meaning that the value of each remaining share goes up in value. Though there is no practical improvement in the sales of a company's goods, customer satisfaction, or efficiency gains in the production process, share prices go up through the removal of share volume. At the level of buybacks seen today, it is hard to understand the practice as anything other than manipulation of share prices.

Stock Buybacks and Conflicts of Interest

One of the major problems with stock buybacks is that corporate executives often hold large amounts of stock themselves, and their compensation is often tied to an increase in the company's earnings per share (EPS) metric. That gives executives a personal incentive to time buybacks so that they can profit off of a rising share price. Usually a majority of corporate executives' pay is from "performance-based pay," which is either directly paid in stock or compensation based on rising EPS metrics (Larckar and Tayan). That means that the decision of whether and when to execute a stock buyback can affect his or her compensation by tens of millions of dollars.

Despite these facts—that stocks constitute a substantial proportion of executives' pay, and that stock buybacks provide a way for executives to raise their pay by millions of dollars—the rules that govern how the company authorizes stock buyback programs fail to account for this significant conflict of interest. The decision to authorize a new stock buyback program is made by the board of directors, including interested directors (those who hold significant shares of stock). The actual execution of buybacks is left to the executives and financial professionals inside the companies, with no board oversight as to the timing or amount of such buybacks, as long as the buybacks stay within the limit previously authorized. As long as directors are using their best “business judgment” to authorize programs, there is no recourse to hold directors accountable for extremely high repurchase programs. Further, executives are required to disclose the monthly volume of actual open-market repurchases, but only after the fact. This means that longer-term investors who hold a small amount of stock, and who could be disadvantaged by the decision to execute a stock buyback program if it is at the expense of investments that could lead to the company’s long-term growth, have no say whatsoever in the company’s decision-making process.

Stock Buybacks and Failure of Government Oversight

A final set of problems with stock buybacks is the lack of government oversight or public accountability as to whether or not companies are staying within the SEC’s safe harbor. Stock buybacks that are higher than the safe harbor’s volume limits would, in theory, be subject to action by the SEC for market manipulation. But because the data is not actually collected as to whether or not a company’s buybacks are within the daily safe harbor limits or not (data is reported by month rather than by day), and is not required to be collected, it is impossible for the SEC to bring such actions. In response to a letter from Senator Tammy Baldwin in 2015, then-SEC Chair Mary Jo White said, “because Rule 10b-18 is a voluntary safe harbor, issuers cannot violate this rule” (*The Intercept* 2015). To date, the SEC has not investigated companies for violating the daily limit because “performing data analyses for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available.” Correcting this data collection problem is under the purview of the Securities and Exchange Commission, yet they have failed to act.

THE ECONOMIC CONSEQUENCES OF STOCK BUYBACKS

There are several economic consequences of stock buybacks. Stock buybacks have made both wealth and income inequality worse. Stock buybacks further increase wealth inequality because the gains that result from the practice of stock buybacks are concentrated among the already-wealthy, who skew white and male (Dettling et al. 2017). According to research by Edward Wolff (2014), less than half of American households own stock, either directly or through a retirement account, whereas 94 percent of households in the top 1 percent of the income distribution own stock. The disparity is even clearer when considering the dollar value of stock ownership: Less than a third of households own at least $10,000 of stock, whereas 93 percent of households in the top 1 percent of the income distribution own stock valued at $10,000 or more.

This disparity is further stratified by race. Families of color face the generational inequities of racism, resulting in less wealth passed down from generation to generation and less opportunity to accumulate wealth in the current generation (Darity Jr. et al. 2017). The Federal Reserve's Survey of Consumer Finance (SCF) found that around 60 percent of white households have retirement accounts and/or hold direct equity in the stock market, while only 34 percent and 30 percent of black and Latino households, respectively, have retirement accounts (Dettling et al. 2017).

Because the use of corporate cash for buybacks has meant that less is available for employees, stock buybacks have also played a significant role in increasing income inequality (Palladino 2018a). As long-term productivity growth becomes less important, employees have less claim to firm profits—which partially explains why wages have remained stagnant. The pressure to reward shareholders has also driven companies to cut costs by fissuring their workforce—contracting work out and outsourcing work to smaller companies, thereby breaking the employer-worker relationship (Weil 2014). In theory, the corporate cash spent on buybacks could pay for major wage increases for employees, improving worker loyalty, productivity, and prosperity (Palladino 2018b). One analysis of the 2017 corporate tax cuts found that, as of February, company benefits to workers were worth $6 billion, while company benefits to shareholders were valued at $171 billion; in other words, nearly 30 times as much money is flowing to shareholders than to employees (Egan 2018). Empirical analysis has linked rising shareholder payouts with declining employee compensation (Lin 2016).

Finally, stock buybacks can negatively affect long-term holders of corporate stock, as executives chasing short-term returns sacrifice the very investments that make firms more profitable in the long run. Stock buybacks may also hurt long-term shareholders, because they may experience declining market value as a result of companies cutting back on investment, after the initial "sugar high" of share price increase due to stock buybacks (Alsin 2017). J.W. Mason (2015a) found that corporate cash flow and borrowing used to fund productive investment, but since the 1980s, fixed investment has declined as shareholder payouts have risen. More recently, Goldman Sachs reported that corporate reinvestment is up only 3 percent following passage of the tax law, while the bulk of the windfall flows to shareholders (Mullaney 2018).

POLICY SOLUTIONS

Given the problems with stock buybacks and the serious consequences they have for our economy, it is past time for policymakers to address the explosive growth of stock buybacks. There are several steps policymakers can and should take to limit their harm:

- First, policymakers should repeal the SEC's safe harbor rule, which opened the door for stock buybacks to become the common corporate practice they are today. In its place, Congress or the SEC should affirmatively ban open-market share repurchases.
- In the meantime, the SEC can and must take steps to enforce potential violations of market manipulation for shares purchased outside of the "safe harbor" by requiring companies to provide data daily, so as to provide the SEC with the information necessary to assess whether any potential violations are occurring.
- Additionally, the SEC can and should take immediate steps to require all shareholders—rather than only directors—to authorize stock buybacks programs and to mitigate the harm to longer-term investors. The SEC should also give directors oversight over certain decisions related to the timing of specific purchases to mitigate the effects of executives' compensation-related conflicts of interest.
- Finally, Congress should repeal much of the Tax Cuts and Jobs Act and raise the effective corporate, highest marginal individual, and capital gains rates that have led to this rash of stock buybacks and that incentivize profit hoarding at the top in lieu of productive investment.

Of course, simply curbing or ending the practice of open-market share repurchases will not, in and of itself, cause firms to productively invest or raise employee compensation. Shareholder gains could be channeled through increased dividends, or corporations could simply sit on larger piles of cash. However, the long-term project to end the dominance of shareholder primacy within America's largest public corporations—our biggest employers—is necessary in order to build sustainable prosperity for all in the 21st century. In forthcoming work, the Roosevelt Institute will propose specific policy interventions to curtain this shareholder primacy. Ending the ability of companies to spend billions of dollars on stock buybacks is an important step towards this goal—and toward a better economic future for all.

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