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How Stock Buybacks Make Americans Vulnerable to Globalization

AIR Working Paper #16-0301

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Revised - March 1, 2016

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December 20, 2015
(updated March 1, 2016)

Think Piece for the workshop on
Mega-Regionalism – New Challenges for Trade and Innovation
East-West Center, Honolulu HI, January 20-21, 2016

Funding for the research in this paper has come from the Institute for New Economic Thinking (project on Collective and Cumulative Careers), Ford Foundation (project on Financial Institutions for Innovation and Development), and the European Commission (project on Innovation-fuelled, Sustainable, Inclusive Growth).

Bibliographic note: For the sake of brevity, in this paper I have kept both documentation of the arguments and bibliographic references to a minimum. For further empirical documentation and bibliographic citations as well as my theoretical perspective, see William Lazonick, *Sustainable Prosperity in the New Economy? Business Organization and High-Tech Employment in the United States*, W. E. Upjohn Institute for Employment Research, 2009; William Lazonick, "The Financialization of the U.S. Corporation: What Has Been Lost, and How It Can Be Regained," *Seattle University Law Review*, 36, 2013: 857-909; William Lazonick, "Innovative Enterprise and Shareholder Value," *Law and Financial Markets Review*, 8, 1, 2014: 52-64; William Lazonick, "Taking Stock: Why Executive Pay Results in an Unstable and Inequitable Economy," Roosevelt Institute White Paper, June 5, 2014; William Lazonick, "Profits Without Prosperity: Stock Buybacks Manipulate the Market and Leave Most Americans Worse Off," *Harvard Business Review*, September 2014, 46-55; William Lazonick, "Labor in the Twenty-First Century: The Top 0.1% and the Disappearing Middle Class," in Christian E. Weller, ed., *Inequality, Uncertainty, and Opportunity: The Varied and Growing Role of Finance in Labor Relations*, Cornell University Press, 2015: 143-192; William Lazonick, "Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute," Center for Effective Public Management, Brookings Institution, April 2015; and William Lazonick, "Buybacks: From Basics to Politics," AIR Special Report, The Academic-Industry Research Network, August 19, 2015. Further research, much of it focusing on particular industries and companies, can be found on the website of the Academic Industry Research Network: www.theAIRnet.org and in posts on the Harvard Business Review Blog Network at hbr.org/search?term=william+lazonick.

The Top 0.1% and the Disappearing Middle Class

There is an integral relation in the U.S. economy between the explosion of the incomes of the richest households and the erosion of middle-class employment opportunities. Since the early 1980s, employment relations in U.S. industrial corporations have undergone three major structural changes, summarized as "rationalization," "marketization," and "globalization," that have eliminated existing middle-class jobs in the United States. Exacerbating the rate of job loss and limiting business investment in new career employment opportunities has been the financialization of the business corporation, manifested by massive stock buybacks in addition to dividend payments.

From the early 1980s, *rationalization*, characterized by plant closings, terminated the jobs of high-school educated blue-collar workers, most of them well-paid union members. From the early 1990s, *marketization*, characterized by the end of a career with one company as an employment norm, placed the job security of middle-aged white-collar workers, many of them college educated, in jeopardy. From the early 2000s, *globalization*, characterized by the offshoring of employment to lower-wage nations, has left all U.S. workers vulnerable to displacement, whatever their educational credentials and employment experience.

These structural changes in employment relations were, initially, business responses to changes in technologies, markets, and competitors. In the early 1980s, permanent layoffs of blue-collar workers were a reaction to the superior productive capabilities of Japanese competitors in consumer-durable and related capital-goods industries. In the early 1990s, the erosion of the one-company-career norm among white-collar workers was a response to the dramatic technological shift from proprietary systems to open systems, integral to the microelectronics revolution; a shift that favored younger workers with the latest computer skills, acquired in higher education and transferable across companies, over older workers with many years of company-specific experience. In the early 2000s, the sharp acceleration in the offshoring of jobs was a response to the emergence of large supplies of highly capable, and lower wage, labor in developing nations such as China and India which, linked to the United States through inexpensive communications systems and global value chains, could take over those U.S. employment activities that had become routine.

Once U.S. corporations transformed their employment relations, however, they often pursued rationalization, marketization, and globalization to cut current costs rather than to reposition their organizations to produce competitive products. Defining superior corporate performance as ever-higher quarterly earnings per share (EPS), companies turned to massive stock repurchases to "manage" their own corporations' stock prices. Trillions of dollars that could have been spent on innovation and related job creation in the U.S. economy over the past three decades have been used instead to buy back stock for the purpose of manipulating stock prices.

Legitimizing this financialized mode of corporate resource allocation has been the ideology, itself a product of the 1980s and 1990s, that a business corporation should be run to "maximize shareholder value" (MSV). Through their stock options and stock awards, corporate executives who make these resource-allocation decisions are themselves prime beneficiaries of rising stock prices and EPS. While rationalization, marketization, and globalization have undermined stable and remunerative employment relations that characterized the post-World War II decades, the financialization of the U.S. corporation has ensured that new employment relations that support stable and equitable economic growth have not been instituted to take their place. Rather the top priority of senior corporate executives has been MSV, manifested by massive stock repurchases, often in addition to generous cash dividends. Incentivizing these distributions has been the stock-based remuneration of top corporate executives. Over the past decade, moreover, at an accelerating rate, hedge-fund activists have joined in the feeding frenzy in a process that can only be described as the legalized looting of the U.S. industrial corporation.

Drawing on a large and growing body of research, I summarize how rationalization, marketization, and globalization have eroded middle-class employment opportunities since the 1980s. Then I document the extent to which over the same time-period financial interests, including senior corporate executives, have extracted cash from companies in the name of MSV. Finally I indicate why this value-extracting activity has rendered ineffective traditional macroeconomic and international trade policy. I call for a policy focus on the governance of business enterprise to support stable and equitable growth.

Disappearance of Middle-Class Employment Opportunities

Rationalization: During the post-World War II decades, the employment norm for both blue-collar and white-collar workers in major U.S. business corporations was a career with one company. Layoffs tended to be temporary and, in unionized workplaces, on a last-hired, first-fired basis. Supported by a progressive income tax system, countercyclical government fiscal policy sought to reduce the severity of business fluctuations, while employment generated by ongoing government spending on higher education, healthcare, and advanced technology as well as transportation, communication, and energy infrastructure complemented and increased the middle-class employment opportunities provided by the business sector. The result from the late 1940s to the beginning of the 1970s was relatively stable and equitable economic growth, especially for households headed by white males.

From the late 1970s, however, U.S. corporations faced formidable Japanese competition in industries such as automobiles, consumer electronics, machine tools, steel, and microelectronics in which U.S companies had been world leaders. Compared with the Japanese, U.S. producers lacked shop-floor learning. Unionized blue-collar workers had a high degree of employment security in the post-World War II era, but they were excluded from the processes of organizational learning within the enterprise, reflecting a uniquely American hierarchical segmentation between "management" and "labor." The prime source of Japanese competitive advantage was the extension of organizational learning from college-educated professional, technical, and administrative employees to shop-floor production workers so that both groups working together could contribute to productivity improvements. Complementing this hierarchical integration of the learning of white-collar and blue-collar workers was the collaboration of Japanese technical specialists in solving productivity problems in manufacturing. The functional integration of their skills and efforts contrasted with the relatively high degree of functional segmentation of technical specialists in business enterprises in the United States.

The adverse impact on U.S. employment of Japanese competition in consumer electronics, automobiles, steel, and machine tools became particularly harsh in the double-dip recession of 1980–1982 when large numbers of blue-collar jobs permanently disappeared from U.S. industry. Previously, in a more stable competitive environment, U.S. manufacturing companies would lay off workers with the least seniority in a downturn and re-employ them when economic conditions improved. In the 1980s, however, it became commonplace for companies to shutter whole plants, often with a view toward boosting stock prices.

In historical retrospect, we now know that the recoveries that followed the recessions of 1990–1991, 2001, and 2007–2009 were "jobless": GDP growth was not accompanied by job growth. In aggregate, the recovery from the recessionary conditions of 1980–1982 was not "jobless" because employment opportunities created by the microelectronics boom in the first half of the 1980s offset the joblessness that remained in the traditional manufacturing sector as the U.S. economy began to grow. In the expansion of 1983–1985, however, production workers in traditional manufacturing industries experienced the first of four jobless recoveries of the last three decades.

Marketization: The recovery from the recession of 1980–1982 saw the emergence of the Wintel architecture around the IBM PC. Competition based on the proprietary technology systems gave way to open technology systems. With the microelectronics revolution of the 1980s, "New Economy" companies in the information and communication technology (ICT) industries found themselves in competition for professional, technical, and administrative labor with "Old Economy" ICT companies such as Hewlett-Packard, IBM, Motorola, Texas Instruments, and Xerox that in the 1980s still offered employees the realistic prospect of a career with one company.

As young firms facing a highly uncertain future, New Economy companies could not use the promise of career employment to bid away technical and administrative labor from Old Economy companies. Instead, they used stock options to attract these employees. At successful New Economy companies that grew large, most, if not all, employees were partially compensated by options. When stock prices soared in the late 1990s Internet boom, these companies suffered from hypermobile labor as valued employees cashed in their options and sought new fortunes with startup firms or took very early retirement. When the boom turned to bust in 2001-2002, these New Economy firms faced disgruntled employees whose options were so far "under water" to be worthless. Boom and bust thus wreaked havoc with organizational learning and hence product development.

Old Economy companies such as IBM, Hewlett-Packard, and Motorola had valued career employees because of their experience in developing and utilizing the company's proprietary technologies. At many of the leading companies, the corporate research lab was the main source of this intellectual property. Investment in new products and processes was often done on military contracts, with the adaptation of the technologies to commercial production as process technologies improved and unit costs fell through economies of scale. Old Economy companies passed on some of the productivity gains to employees in the forms of higher wages and job security, thus supporting higher living standards in the U.S. economy. In short, the Old Economy norm of a career with one company provided the foundation for relatively stable and equitable growth in the post-World War II decades.

The recession and recovery of the early 1990s witnessed the marketization of the employment relation and marked the beginning of the end of the career-with-one-company norm at Old Economy enterprises. In the recession of the early 1990s unemployment was higher for blue-collar than for white-collar workers. But as a result of the unprecedented permanent layoffs of professional, technical, and administrative employees, the downturn of 1990–1991 became known as the "white-collar recession." Increasingly over the course of the 1990s, including during the Internet boom in the second half of the decade, the career-long employment security that people in their forties and fifties had come to expect under the Old Economy business model vanished as employers in established companies replaced more-expensive older workers with less-expensive younger workers.

Globalization: In the 2000s globalization joined rationalization and marketization as a source of structural change in U.S. employment relations. In the ICT industries that were central to the growth of the U.S. economy in the 1980s and 1990s, the globalization of employment dated back to the 1960s, when U.S. semiconductor manufacturers had set up assembly and testing facilities in East Asia, making use of low-paid but literate female labor. The productivity of these plants also depended on the availability of knowledgeable and motivated managers and engineers, virtually all male. Over time, a combination of work experience with multinational and indigenous companies and the return of nationals who had acquired graduate education and work experience abroad enhanced the capability of the Asian labor force to engage in higher value-added activities.

By the beginning of the 2000s, Indians had become world leaders in the offshore provision of IT services, while the Chinese had become adept in a wide range of manufacturing industries, especially in ICT. China and India inserted themselves into the global value chains that were characteristic of the New Economy business model. In the 2000s the availability of capable, college-educated labor in developing economies along with high-quality, low-cost communication networks enabled a vast acceleration of the movement of jobs by U.S. companies to China and India. In both nations, indigenous and foreign high-tech companies were by the 2000s well positioned to move rapidly up the global value chains.

Offshoring depressed U.S. employment in the recession of 2001 and in the subsequent jobless recovery that stretched into 2003. As U.S.-based companies hired workers abroad, well-educated high-tech workers in the United States found themselves vulnerable to displacement. Given huge increases in the issuance of nonimmigrant (H-1B and L-1) work visas in the United States in the late 1990s and early 2000s, there were hundreds of thousands of high-tech workers, especially Indians, who had accumulated U.S. work experience that they could now take back home. In February 2003, after more than a year of jobless recovery, *BusinessWeek* gained considerable attention when its cover blared the rhetorical question: "Is Your Job Next?"[1] The subtitle read: "A new round of globalization is sending upscale jobs offshore. They include chip design, engineering, basic research – even financial analysis. Can America lose these jobs and still prosper?"

Rationalization, marketization, and globalization continue to erode middle-class employment in the United States. In 2014 the U.S. rate of business-sector unionization was 6.6%, having declined steadily from more than 15% in 1983.[2] Since the early 1990s, nonunionized white-collar workers, including professional, technical, and administrative employees who are deemed to be members of "management," have found that they can no longer expect a career with one company. The shift to open-systems technologies and the globalization of high-tech jobs have rendered highly educated and highly experienced members of the U.S. labor force vulnerable to loss of career employment.

Meanwhile since 1960, through a policy that exempts U.S. companies from paying corporate taxes on their foreign profits until those profits are repatriated to the United States, the U.S. government has given U.S. companies an incentive to make profits abroad and keep them there. The Obama administration promised to get rid of this tax loophole, but, even before the Republicans took control of the House of Representatives in November 2010, the President caved in the presence of vociferous opposition from high-tech executives.

The elimination of middle-class jobs has often had a productive rationale: manufacturing plants may become uncompetitive; recently educated workers may possess more relevant skills than experienced (older) workers; and the productive capabilities of workers in low-wage areas of the world may be on a par with, if not superior to, those of workers in the United States. Nevertheless, once changes in the structure of employment have become widespread for productive reasons, corporations have been known to terminate employees in order to increase short-term profits for the sake of inciting speculative increases in their companies' stock prices. Under a regime of financialized corporate resource allocation, the tendency has

[1] Pete Engardio, Aaron Bernstein, and Manjeet Kripalani, "The great global job shift," *BusinessWeek*, February 3, 2003.
[2] Bureau of Labor Statistics, "Union Members—2014," January 23, 2015, at http://www.bls.gov/news.release/union2.nr0.htm.

then been to allocate those extra profits to stock buybacks, often in addition to dividends, for the purpose of giving a company's stock price a manipulative boost.

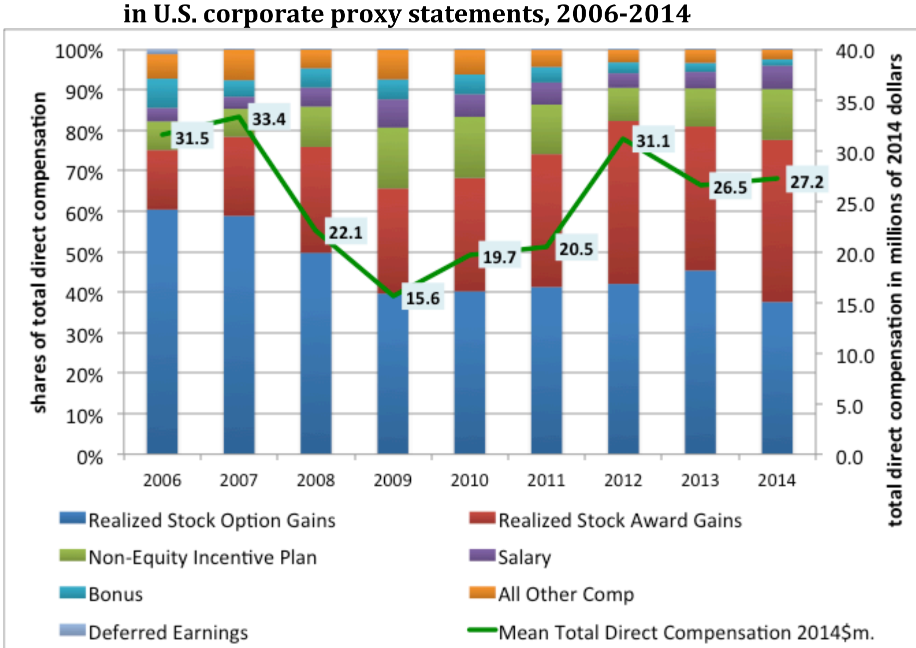
Unlike the recessions of 1980–1982, 1990–1991, and 2001 that were exacerbated by structural changes in employment relations, the Great Recession of 2008–2009 was a purely financial downturn caused by speculation in, and manipulation of, securities markets. Financial interests exploited the fragility of home ownership in an economy that since the 1980s had been eliminating the stable and remunerative jobs that had made home ownership affordable. The jobless recovery that followed the Great Recession was far more prolonged than earlier ones.

While Wall Street has become, and remains, a gambling casino, the more fundamental fragility of the U.S. economy emanates from the industrial sector to which the vast majority of households look for employment that can sustain middle-class living standards. Rationalization, marketization, and globalization, however, have eliminated middle-class employment opportunities. As a general rule, the executives who run U.S. industrial corporations have become focused on creating profits for the sake of higher stock prices rather than investing in high value-added jobs that can generate innovative products. Even when growth is achieved, it tends to be unstable and inequitable.

Concentration of Income at the Top

Since the late 1970s, there has been concentration of income among the richest households in the United States, among which corporate executives are a well-represented group. As Figure 1 shows, most of the total compensation of the 500 highest-paid U.S. executives has come from realized gains from exercising stock options and the vesting of stock awards. Together, for 2006-2014 realized gains from stock-based compensation represented 76% of total compensation of the 500 highest-paid executives.

Figure 1. Mean total direct compensation and its components in percentages for the 500 highest-paid executives named annually in U.S. corporate proxy statements, 2006-2014



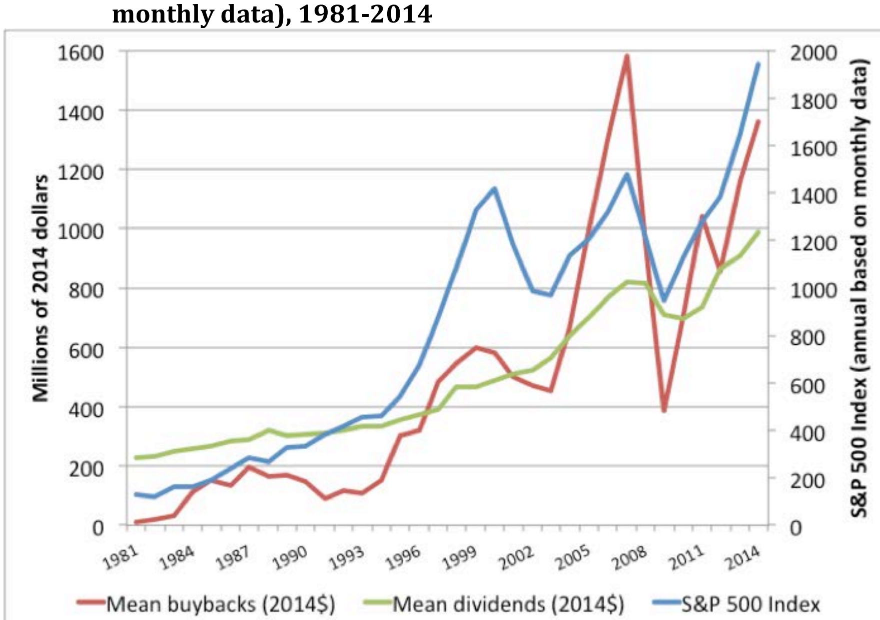
Source: Standard &Poor's Execucomp database

Yet the problem that outsized executive compensation creates for the achievement of stable and equitable economic growth is not the high level of executive compensation per se. The problem is the incentives that stock-based pay have given to senior executives to allocate corporate resources to *extract value* from the company through distributions to shareholders rather than to *create value* in the company through investments in productive capabilities. In addition to dividends, over the past three decades, as the prime manifestation of the financialization of the U.S. business enterprise, corporate executives, with the authorization of their boards of directors and (as explained below) encouragement from the U.S. Securities and Exchange Commission (SEC), have allocated trillions upon trillions of dollars to buying back their companies' own stock.

Until the mid-1980s buybacks were insignificant. But since then, buybacks have become massive and pervasive. For the decade 2006-2015, U.S. nonfinancial corporations' total net equity issues – new share issues less shares taken off the market through buybacks and merger-and-acquisition deals – averaged *minus $416 billion per year*.[3] Given the importance of these corporations to the operation and performance of the economy, it is fair to say that in the 21st century the U.S. industrial economy has become a "buyback economy."

In aggregate, dividends have tended to increase as a proportion of corporate profits. Yet in 1997 buybacks surpassed dividends in the U.S. corporate economy. While buybacks are more volatile from year to year than dividends, they have become more dominant as a mode of distribution of corporate cash to shareholders. Figure 2 shows buyback and dividend expenditures in 2014 dollars for 243 companies in the S&P 500 Index in February 2015 that were publicly listed from 1981 through 2014.

Figure 2. Common stock repurchases and cash dividends, 243 companies in the S&P 500 Index in Feb. 2015 publicly listed from 1981 through 2014, and the S&P 500 Index (annual averages of monthly data), 1981-2014



Sources: S&P Compustat database, verified and corrected by Mustafa Erdem Sakinç; S&P 500 Index from Yahoo! Finance, annual averages of monthly data.

[3] Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release Z.1, "Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts," Table F-223: Corporate Equities, December 10, 2015.

Figure 2 also shows the relation of these distributions to the movement of the S&P 500 Index. In the early 1980s repurchases were a small fraction of dividends, but in 1997 surpassed them as a mode of distributing corporate cash to shareholders. Over the past two decades buybacks have been done during periods of high stock prices, helping to push the S&P 500 Index to new peaks.

Over the decade 2005-2014, 459 companies in the S&P 500 Index in February 2015 that were publicly listed over decade expended \$3.8 trillion on stock buybacks, representing 52.7% of net income, plus another 35.7% of net income on dividends. Much of the remaining 11.6% of profits was held abroad, sheltered from US taxes. Many of America's largest corporations routinely distribute more than 100% of net income to shareholders, generating the extra cash by reducing cash reserves, selling off assets, taking on debt, or laying off employees.

The earnings that a company retains after distributions to shareholders have always been the financial foundation for investment in innovation and sustained employment. These retained earnings can fund investment in plant and equipment, research and development, and, of prime importance but invisible in reported company data, 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 that they manage.

Dividends are the legitimate way for a publicly-listed corporation to provide income to shareholders. They receive dividends 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 will help lift its future stock price. When, for whatever reason, shareholders who have benefited from a stream of dividend income on their holdings decide to sell some or all of their shares, they stand to make a capital gain.

In contrast, by creating demand for the company's stock that provides an immediate boost to its stock price, buybacks reward existing shareholders for *selling* their shares. The most prominent sharesellers are those stock-market traders, including corporate executives, investment bankers, and hedge-fund managers, who are able to time their stock sales to take advantage of buyback activity done as open-market repurchases. Buybacks also automatically increase EPS by decreasing the number of shares outstanding. Since EPS has become a major metric by which financial interests evaluate the performance of a company, buybacks tend to increase demand for a company's stock, thus creating opportunities for stock-market speculators to sell their shares at a gain, even in the absence of increased corporate revenues or profits. Besides top corporate executives, the other big winners from stock buybacks are investment bankers and hedge-fund managers.

Stock buybacks give manipulative boosts to a company's stock price. Under SEC Rule 10b-18 that since November 1982 has "regulated" buybacks done on the open market, neither the SEC nor the general public knows the particular days on which open-market repurchases are actually being executed. But top executives do, and investment bankers and hedge-fund managers are in the business of figuring it out and timing their stock trades to profit from buybacks.

But neither a hedge fund nor any other party that buys shares outstanding on the market – that is, shares that are not sold directly by a company in a public offering – provides the company with money that it can invest in productive capabilities. Without having contributed anything to a company's development or success, activist hedge funds seek to extract from companies money derived from the value that other people have financed and, through their efforts, generated. And with their ample stock-based pay, senior corporate executives collaborate in this process of value extraction. Tens of millions of Americans go to work every day to create value in the companies that employ them, only to have this value extracted by stock-market speculators and manipulators who have typically played little if any role in the value-creation process. As a result, the employment security of U.S. workers is ever more precarious while they are denied shares in their companies' productivity gains that their time and effort helped to create.

Research on particular industries and companies shows clearly why almost everybody pays the price for stock buybacks.[4]

- Pharmaceutical companies in the United States charge far higher drug prices than anywhere else in the world, claiming that they use these higher revenues to spend more on R&D that generates medical innovation. Yet (as elaborated below) many of the largest U.S. drug companies such as Pfizer, Merck, and Amgen have persistently distributed well over 100% of their profits to shareholders as buybacks and dividends.
- Many health insurance companies such as UnitedHealth Group, Aetna, and Wellpoint charge Americans high premiums and out-of-pocket expenses while spending upwards of 70% of net income on buybacks. Meanwhile, their executives reap tens of millions of dollars in stock-based pay.
- High-tech companies such as IBM, HP, Intel, Microsoft, and Cisco lay off thousands of experienced employees while doing billions of dollars in buybacks – and failing to invest sufficiently in future innovation. The "downsize-and-distribute" strategy of handing out cash to shareholders while laying off workers contrasts with a "retain-and-reinvest" strategy through which a company provides its workers with employment stability so that they can accumulate the productive capabilities essential to innovative enterprise.
- Petroleum-refining companies such as Exxon Mobil – which leads all companies worldwide in repurchases at about $22 billion per year – Chevron, and ConocoPhillips do massive stock buybacks while taking government subsidies for oil exploration and neglecting investments in alternative energy.
- General Motors, which spent over $20 billion on buybacks from 1986 to 2002 while losing market share, agreed to do $5 billion in buybacks in 2015 and 2016 after a group of hedge funds, represented by the main architect in the Obama administration's 2009 bailout of GM, demanded $8 billion in buybacks and a seat on the GM board. Yet U.S. taxpayers lost $11 billion bailing GM out of bankruptcy, while autoworkers gave up multiples of that amount in lost jobs, wage concessions, and retiree benefit reductions.
- Over the past decade McDonald's has done almost $3 billion per year in buybacks along with ample dividends. With revenues falling, McDonald's recently announced its intention to borrow $10 billion to increase its annual buybacks as part of its "turnaround" plan. With the fast-food corporation bent on "maximizing shareholder value," McDonald's franchisees bear all the costs of store renovations and product promotion while squeezing already low-paid workers to try to eke out profits.
- The only time in its history that Apple, now the most profitable company in the world, has raised funds from the public stock market was in 1980, when its initial public offering brought in $97 million. Yet at the behest of hedge-fund activists David Einhorn and Carl Icahn, Apple has done $103 billion in buybacks in three years through September 2015, thus forgoing a golden opportunity to provide leadership to corporate America in ensuring the allocation of resources to workers and taxpayers who actually have contributed, and continue to contribute, to the company's success.

Taking Back the Buyback Economy

[4] This research can be found at www.theAIRnet.org.

On its website the SEC states that it "protects investors, maintains market integrity, and facilitates capital formation."[5] In permitting, and even encouraging, buybacks that manipulate the stock market, however, the SEC has been undermining its own stated mission. Since November 1982, under Rule 10b-18, the SEC provides a corporation with a safe harbor against charges of stock-price manipulation if its open-market repurchases on any single trading day do not exceed 25% of its average daily trading volume over the preceding four weeks. Companies do not have to disclose, at the time or after the fact, the particular days on which these repurchases are executed. Under Rule 10b-18, the most actively traded companies can do hundreds of millions of dollars of buybacks per trading day while remaining within the safe-harbor limit. In effect, for over three decades, far from protecting investors, maintaining market integrity, or facilitating capital formation, the U.S. government agency that is charged with regulating the stock market has given business corporations licenses to manipulate it.

The adoption of SEC Rule 10b-18 was a direct result of the election of Ronald Reagan to the U.S. Presidency on a platform of market deregulation. Wall Street executive John Shad, who Reagan appointed in 1981 to head the SEC, argued that Rule 10b-18 would help fuel stock prices. At the same time, Shad adhered to the free-market notion that the costs of regulation outweigh the potential gains from the detection of illegal activity. From this perspective, a requirement for companies to disclose their daily buyback activity would undermine the efficiency of capital markets.

Recently, federal legislators have begun to question the SEC on the wisdom of Rule 10b-18. On April 23, 2015, Sen. Tammy Baldwin (D-WI) wrote to SEC Chair Mary Jo White "with concerns about the recent explosion of stock buybacks by U.S. corporations."[6] Sen. Baldwin requested that the SEC, "as the regulator responsible for fair and efficient capital markets, provide the following: any analytic work done by the SEC on the long-term economic impact of the 1982 rule [i.e., Rule 10b-18]; an accounting of all investigations undertaken by the SEC into possible violations of the rule; and an assessment of whether this rule is adequate for the SEC's stated mission – to foster capital formation and prevent fraud."

In her response to Sen. Baldwin on July 13, 2015, SEC Chair White had nothing to say about the long-term impacts of Rule 10b-18, including its implications for capital formation and fraud prevention.[7] She informed the Senator that, for SEC economists, "[p]erforming data analyses for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available." These critical data are lacking because Rule 10b-18 does not require companies to disclose the particular days on which they do stock buybacks.

Chair White did say that while the SEC has "a long history of bringing enforcement actions against persons alleged to have manipulated common stock prices," it could not investigate possible violations of Rule 10b-18. Why? As Chair White explained: "Because Rule 10b-18 is a voluntary safe harbor, issuers cannot violate this rule." In other words, Rule 10b-18 is a license to use open-market repurchases to manipulate stock prices.

On November 16, 2015, Sen. Baldwin sent a second letter to Chair White,[8] writing:

> I remain seriously concerned with the scope and extent of share buybacks and their potentially manipulative effect on short-term share prices and your previous response

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[5] http://www.sec.gov/about/whatwedo.shtml
[6] http://www.baldwin.senate.gov/download/?id=2c78cb92-3afd-453c-bae3-44a875ac11ab&download=1
[7] https://www.documentcloud.org/documents/2272283-sec-response-to-baldwin-07132015.html#document/p1
[8] http://www.baldwin.senate.gov/download/?id=2d90191b-ed0f-4865-84d6-2980b165fad0&download=1

did not sufficiently explain what the SEC is doing to respond to the buyback phenomenon. Accordingly, I request that you respond to the following questions:

- What steps are you taking to investigate the risk that share buybacks could be manipulating stock price?
- Have you opened any investigations into questionable buyback practices?
- Given that you have explained that the Commission lacks the necessary data to perform analysis on buybacks, are you working to improve your data collection efforts?

While posing these specific questions and asking for daily disclosure of buybacks as well as annual disclosure by companies of the performance metrics that affect executive pay, Sen. Baldwin makes it clear to Chair White that she is interested in the adverse impact of stock repurchases on the performance of the economy as a whole: "The overarching reason I am interested in buybacks is that I am concerned that they come at the expense of the investments in innovation, research and workers that are necessary for stable and equitable economic growth, as some academic studies have suggested."[9]

Also raising questions about buybacks has been Sen. Elizabeth Warren (D-MA). In September 2014, at a U.S. Senate hearing on economic inequality, she invoked distributions to shareholders as the fundamental reason for the decline of shared prosperity in the United States since the 1980s.[10] In a penetrating speech on "the unfinished business of financial reform" delivered in April 2015, she argued that "we can put in place strong, enforceable securities rules that don't create incentives for CEOs to use stock buybacks as a way to manipulate prices in the short-term, rather than investing in the long-term health of their companies."[11] In a *Boston Globe* interview in June, she was highly critical of corporations for practicing, and of the SEC for permitting, stock-price manipulation by the use of buybacks.[12]

Vice President Joe Biden has argued that buybacks are at workers' expense. In a speech at the first White House Summit on Worker Voice, he cited the data from my *Harvard Business Review* article "Profits Without Prosperity" on the extent to which buybacks and dividends have absorbed the lion's share of corporate profits, leaving very little retentions available for the growth of the business, increases in R&D, and wage and salary raises. The Vice President said that he had become focused on the damaging impacts of buybacks when he had been in charge of a White House study "to put together a proposal to make sure that we had the best-trained workforce in the world." After eight months of study, the taskforce found that "businesses aren't reinvesting in retraining workers. Why?. . .In the old days [businesses] would actually go train personnel, but now they want the government to do it." Biden gave three reasons for that change in business behavior: 1) Reagan's SEC appointments that resulted in companies being granted the right to buy back all the stock they want; 2) wealth concentration at the top that has taken money away from the middle class; and 3) a tax structure through which "we reward unearned income more than we ever have in our history, as opposed to earned income – a paycheck."[13]

The buyback problem has entered the campaigns for the Democratic presidential nomination. Sen. Bernie Sanders (I-VT) was first out of the gate in June with an op-ed in the *Boston Globe*

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9 Here Sen. Baldwin refers to Lazonick, "Stock Buybacks" and Lazonick, "Profits Without Prosperity." She also refers in her letter to similar concerns from some business executives as well as two SEC Commissioners, Kara Stein, a Democratic appointee, and Daniel Gallagher, a Republican appointee. SEC Chair White responded to Sen. Baldwin in January 29, 2016.

10 http://www.warren.senate.gov/?p=video&id=629

11 http://billmoyers.com/2015/04/18/elizabeth-warren-speech/

12 Michael Kranish, "Warren decries stock buybacks, high CEO pay," *Boston Globe*, June 4, 2015.

13 "The Vice President delivers remarks at the White House Summit on Worker Voice," October 7, 2015, at https://www.whitehouse.gov/photos-and-video/video/2015/10/07/vice-president-delivers-remarks-white-house-summit-worker-voice

(alongside one of mine on buybacks) which followed a major front-page story by journalist Michael Kranish on the damage that buybacks can do.[14] Sen. Sanders wrote: "Instead of putting resources into innovative ways to build their businesses or hire new employees, corporations are pumping their record-breaking profits into buying back their own stock and increasing dividends to benefit their executives and wealthy shareholders at the expense of their workers."

On July 13, buybacks found their way into Hillary Clinton's first major economics speech of her campaign. As she phrased it: "In recent years some of our biggest companies have spent more than half their earnings to buy back their own stock and another third or more to pay dividends. That doesn't leave a lot left to raise pay or invest in the workers who made those profits possible or to make new investments necessary to ensure a company's future success." Later in the speech she continued: "I will also propose reforms to help CEOs and shareholders alike to focus on the next decade rather than just the next day. Making sure stock buybacks aren't being used only for an immediate boost in share prices; empowering outside investors who want to build companies, but discouraging cut and run shareholders who act more like old-school corporate raiders. And nowhere will the shift from short-term to long-term be more important than on Wall Street."[15]

Clearly, as Harold Meyerson put it in a *Washington Post* article on the Clinton speech, Clintonomics had been pushed to the left.[16] He noted the recent publication of a Brookings paper, "More Builders and Fewer Traders: A Growth Strategy for the American Economy," by William Galston and Elaine Kamarck, two former advisors to Bill Clinton, that, drawing on the paper on stock buybacks that I wrote for Brookings Center for Effective Public Management, calls for the repeal of SEC Rule 10b-18 and the regulation of executive pay.[17]

On July 24, Clinton delivered a speech in which she laid out a policy platform to confront the pervasive culture of "quarterly capitalism." Her list of policy reforms (upon which she promised she would elaborate as her campaign unfolds) to replace "short-termism" with "long-termism" focuses on five areas: capital-gains taxes, stock buybacks, executive pay, empowering workers, and stable pro-growth government policy.[18] Citing my article "Profits Without Prosperity," Clinton declared: "We also have to take a hard look at stock buybacks. Investors and regulators need more information about these transactions. Capital markets work best when information is promptly and widely available to all."

If the SEC is going to continue to permit open-market repurchases by companies, it should at least require, as Sen. Baldwin has now requested, each company to reveal immediately its daily buyback activity so that the agency and the public can assess whether stock-price manipulation is going on. It would then also be transparent if executives and other insiders have timed the sales of their own personal holdings of the companies' shares (including those acquired from exercising stock options or the vesting of stock awards) to take advantage of price boosts from buyback activity.[19]

But disclosure by itself would only serve to legitimize buybacks. Stock buybacks manipulate the market and leave most Americans worse off. The ultimate goal of these policy initiatives

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[14] Michael Kranish, "Feast for investors sells workers short; As US companies spend billions repurchasing shares, employees and economy may pay the price," *Boston Globe*, May 31, 2015; Bernie Sanders, "The war on the middle class," *Boston Globe*, June 12, 2015; William Lazonick, "Ban the stock buyback binge, bring back the middle class," *Boston Globe*, June 12, 2015.

[15] "Hillary Clinton transcript: Building the 'growth and fairness economy,'" *Wall Street Journal*, July 13, 2015.

[16] Harold Meyerson, "The new Clintonomics shifts left," *Washington Post*, July 15, 2015.

[17] http://www.brookings.edu/research/papers/2015/06/30-american-economy-growth-strategy-galston-kamarck

[18] https://www.hillaryclinton.com/p/briefing/factsheets/2015/07/24/encourage-long-term-growth/

[19] William Lazonick, "Clinton's proposals on stock buybacks don't go far enough," *Harvard Business Review Blog Network*, August 11, 2015, at https://hbr.org/2015/08/clintons-proposals-on-stock-buybacks-dont-go-far-enough

should to repeal SEC Rule 10b-18, and make the use of buybacks to manipulate the stock market illegal.

The buyback economy bears prime responsibility for the destruction of the American middle class. The acceleration and escalation of hedge-fund activism in recent years are making matters worse.[20] But the growth of the buyback economy long predates the rise of hedge-fund activism, which became a significant force in the mid-2000s. Already in the 1990s, U.S. corporate executives, incentivized by stock-based pay, had embraced the damaging, and erroneous, ideology that companies should be run to maximize shareholder value.[21] The fundamental problem is not the level of executive pay but rather the incentives that it creates among established profitable companies to "downsize-and distribute" rather than "retain-and-reinvest." Both the reversal of the concentration of income at the top and the restoration of the middle class require the transformation of corporate resource allocation so that households who as workers, taxpayers, consumers, and savers contribute to the processes of value creation get their fair shares of corporate returns.

In an era in which what is good for corporate executives, investment, bankers, and hedge-fund activists is clearly *not* what is good for the United States, we must also consider how and to what extent the buyback economy may be undermining the effectiveness of traditional fiscal, monetary, and trade policies that are supposedly carried out in the national interest. Fiscal stimulus will not work if corporations serve the increased demand for their products by squeezing unremunerated effort out their employees, and then use the extra profits to jack up their companies' stock prices by buying back more shares. Monetary stimulus will not work if the easy money pumped into the economy induces corporations to take on more debt to repurchase more stock.

And new international trade agreements will not work if the U.S. corporations that receive more favorable conditions for global investment, sales, and purchases have no interest in sharing those gains with U.S. households back home. Many have criticized the recently released draft of the Trans-Pacific Partnership (TPP) as a U.S.-dominated trade agreement written by U.S. corporations for U.S. corporations. The concerns of U.S. households have been given short shrift.

Yet there is no way that a trade agreement can be implemented without the cooperation and support of large business corporations engaged in the global economy. The performance of the U.S. economy itself is dependent on the investment decisions of a relatively small number of powerful business enterprises. In 2012, 964 companies that had 10,000 or more employees in the United States, with an average workforce of 33,500, were only 0.017% of all U.S. businesses. But these 964 companies had 9% of all establishments, 28% of employees, 31% of payrolls, and 36% of receipts.[22] Once it is recognized that, in the buyback economy, these corporations are no longer functioning in the interests of the vast majority of Americans at home, it should be no surprise that they are not seeking to serve our interests as they seek to shape U.S. government policy in the international economy.

A prime example, as already indicated, is the pharmaceutical drug industry. On December 8, 2015, Rohit Malpani, Director of Policy and Analysis for Doctors Without Borders (Médecins

[20] For an account of growth of hedge-fund activism, see John C. Coffee, Jr., and Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance," The Center for Law and Economic Studies, Columbia University School of Law, Working Paper N. 521, September 4, 2015, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2656325.

[21] See William Lazonick and Mary O'Sullivan, "Maximizing Shareholder Value: A New Ideology for Corporate Governance," *Economy and Society*, 29, 1, 2000: 13-35; William Lazonick, "Innovative Enterprise and Shareholder Value," *Law and Financial Markets Review*, 8, 1, 2014: 52-64.

[22] United States Census Bureau, "Statistics of U.S. Businesses," Data on "U.S., NAICS sectors, larger employment sizes" at http://www.census.gov/econ/susb/

Sans Frontières) delivered an important critique of TPP at a U.S. Congressional hearing on access to medicines under TPP.[23] He argued that, as currently drafted, TPP would result in both higher drug prices and reduced drug development. Increased intellectual property protection under TPP would enhance the ability of pharmaceutical companies to charge high prices on patented drugs while slowing the availability of lower-priced generic drugs. The drug companies contend that these higher prices generate profits that can be reinvested in new drug development. In his testimony Malpani countered that "the sole reliance on high medicine prices, backed by monopolies, is a flawed paradigm for funding innovation." He continued:

> This leads to unaffordable prices while failing to stimulate innovation for diseases disproportionately affecting developing countries, where patients have limited purchasing power. Our current innovation model is also failing patients in developed countries, as with antibiotic resistance. In spite of the need for new antibiotics, pharmaceutical companies, including Pfizer, the world's largest, have abandoned antibiotic drug development. Since antibiotics must be affordable and used sparingly, the industry response has been to withdraw.

Malpani is correct; companies that are concerned with profits, not products, tend to be uninterested in allocating resources to the development of drugs that promise low profit margins. An analysis of how the financialized business corporation, epitomized in pharmaceuticals by Pfizer, actually allocates its profits adds a powerful explanation for the "flawed paradigm for funding innovation" in medical drugs, of which Malpani spoke.[24]

Strong patent protection combined with an absence of price regulation has resulted in U.S. drug prices that are at least twice as high as anywhere else in the world. When the U.S. government has sought to regulate drug prices, pharmaceutical companies have argued that they need high prices to fund investments in innovation. The fact is, however, that the largest drug companies allocate all of their profits and more to buybacks and dividends.

Pfizer, number 56 on the current Fortune 500 list, is a prime example. From 1975 to 1984 Pfizer did no buybacks, distributing 43% of net income to shareholders. But its total payouts to shareholders climbed to 93% in 1985-1994, including 42% in buybacks. For 1995-2004, the company distributed 117% of profits to shareholders, with 72% in buybacks; and for 2005-2014, 110%, of which 71% – $61 billion – were done as buybacks. In 2015, Pfizer handed $12.8 billion, or 165% of net income, to shareholders, including $6.2 billion in buybacks.

Meanwhile from 2010 to 2014 Pfizer's revenues fell from $67.8 billion to $49.6 billion, mainly because of the expiration of the patents on a number of the company's blockbuster drugs, and revenues fell further to $48.9 billion. Pfizer slashed worldwide employment from 110,600 at the end of 2010 to 78,300 at the end of 2014

If we want to be critical of a company like Pfizer for its role in shaping TPP to suit its own corporate interests, then we should start by attacking the company's corrupt business model, asking whose interests the corporation actually serves in the United States. In routinely distributing in excess of 100% of net income to shareholders, Pfizer is pursuing its stated

[23] "MSF's Oral Testimony to the United States House of Representatives Committee on Ways and Means," Hearing on Access to Medicines, U.S. House of Representatives, December 8, 20915, at http://www.msfaccess.org/content/msfs-oral-testimony-united-states-house-representatives-committee-ways-and-means

[24] The following account draws on William Lazonick, Öner Tulum, and Matt Hopkins, "Tax dodging just one part of Pfizer's corrupt business model," *Huffington Post*, December 4, 2015, at http://www.huffingtonpost.com/william-lazonick/tax-dodging-just-one-part_b_8721900.html.

mission of "enhancing shareholder value" even though is at the expense of U.S. households as workers, taxpayers, consumers, and savers.

Pfizer's business model is to merge with other pharmaceutical companies that have proven blockbusters still under patent, and then milk these protected drugs for all of the profits possible until the patents run out. Since 2000 Pfizer has performed this feat with drugs acquired through mergers with Warner-Lambert, Pharmacia, and Wyeth, and in November 2015 Pfizer announced its latest merger with Allergan, possessor of the blockbuster Botox, which, with new indications for its use, will remain under patent for a long time to come. Meanwhile, Pfizer has been unsuccessful in generating revenues from its own originated and developed drugs.

As we have seen, Pfizer distributes in excess of 100% of the profits that it generates from this business model to shareholders as buybacks and dividends. Prime beneficiaries of Pfizer's financialized behavior are its top executives with their ample stock-based pay. In 2014 Ian C. Read, Pfizer's CEO since December 2010, had total direct compensation of $22.6 million, of which 27% came from exercising stock options and 50% from the vesting of stock awards. The other four highest-paid executives named on Pfizer's 2015 proxy statement averaged $8.0 million, with 24% from stock options and 41% from stock awards.

Defending the announced merger with Allergan, which will shift Pfizer's tax home to Ireland with its low corporate tax rates, CEO Read has moaned that Pfizer's U.S. tax bill puts the company at a "tremendous disadvantage" in global competition. "We're fighting," Read said in a Wall Street Journal interview, "with one hand tied behind our back."[25] Yet when one looks at Pfizer's gargantuan distributions to shareholders, it is obvious that if Read cannot make use of both hands to secure finance for new drug development, it is not Uncle Sam who tied the knot. From January 2001 through September 2015, Pfizer paid out $95.5 billion in buybacks and $87.1 billion in dividends, representing 117 percent of its net income. Meanwhile, it provisioned $37.1 billion for U.S. corporate income taxes, much of which are charges on future repatriated profits that may never be actually paid. If Pfizer is cash-constrained, it is likely because of the golden handcuffs of Read's own stock-based pay.

As the case of Pfizer demonstrates, critiques of U.S. business behavior and U.S. government policy in the global economy should start with dismantling the laws and norms that support the financialized business corporation.[26] Stock buybacks are at the center of the American inequality problem because corporate resource allocation is at the core of the economy. For anyone concerned with restoring sustainable prosperity in the U.S. economy, a ban on stock buybacks is the place to start. The movement for a ban on buybacks will in turn put a focus on the highly damaging ideology that business corporations should be run to "maximize shareholder value." With representatives of the interests of households as workers, taxpayers, consumers, and savers on corporate boards, U.S. business corporations can begin to transform their resource allocation regimes from "downsize-and-distribute" to "retain-and-reinvest," putting the United States on a path to stable and equitable economic growth.

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[25] http://www.wsj.com/articles/pfizer-allergan-considering-combining-1446079506

[26] See William Lazonick, Matt Hopkins, Ken Jacobson, Mustafa Erdem Sakinç, and Öner Tulum, "Life Sciences? How "Maximizing Shareholder Value" Increases Drug Prices, Restricts Access, and Stifles Innovation," Submission to the United Nations Secretary-General's High-Level Panel on Access to Medicines, February 28, 2016; [26] See William Lazonick, Matt Hopkins, Ken Jacobson, Mustafa Erdem Sakinç, and Öner Tulum, "U.S. Pharma's Business Model: Why It Is Broken, and How It Can Be Fixed," Submission to the United Nations Secretary-General's High-Level Panel on Access to Medicines, February 28, 2016.

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William Lazonick is professor of economics and director of the Center for Industrial Competitiveness at University of Massachusetts Lowell. He is co-founder and president of The Academic-Industry Research Network. Lazonick is also a visiting professor at the University of Ljubljana, Telecom School of Management (Paris), and Munk School of Global Affairs, University of Toronto. Lazonick's holds a B.Com from the University of Toronto (1968), M.Sc. (Econ) from the London School of Economics (1969), and Ph.D. in economics from Harvard University (1975). In 1991 Uppsala University awarded him an honorary doctorate for his work on the theory and history of economic development. Previously, Lazonick was assistant and associate professor of economics at Harvard University, professor of economics at Barnard College of Columbia University, and distinguished research professor at INSEAD.

The Institute for New Economic Thinking, Ford Foundation, and European Commission are currently funding Lazonick's research. His book Sustainable Prosperity in the New Economy? Business Organization and High-Tech Employment in the United States (Upjohn Institute for Employment, 2009) won the 2010 International Joseph A. Schumpeter Prize. His article, "Innovative Business Models and Varieties of Capitalism," received the Henrietta Larson Award from Harvard Business School for best article in Business History Review in 2010 (Lazonick had previously won the prize for best article in this journal in 1983). His Harvard Business Review article "Profits Without Prosperity: Stock Buybacks Manipulate the Market and Leave Most Americans Worse Off," received the HBR McKinsey Award for outstanding article in Harvard Business Review in 2014. Lazonick is currently completing a book, The Theory of Innovative Enterprise, to be published by Oxford University Press.

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