

**Profits Without Prosperity:
How Stock Buybacks Manipulate the Market,
and Leave Most Americans Worse Off**

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Corporate resource allocation and shared prosperity

Five years after the end of the Great Recession, corporate profits are high and the stock market is booming. Yet most Americans are not sharing in the apparent prosperity. While the top 0.1% of income recipients, the highest-ranking corporate executives among them, reap almost all the income gains, good jobs keep disappearing, and new employment opportunities tend to be insecure and underpaid. Corporate profitability is not translating into shared prosperity.

For this lack of shared prosperity, the allocation of corporate profits to stock buybacks bears considerable blame. From 2003 through 2012, 449 S&P 500 companies dispensed 54% of earnings, equal to \$2.4 trillion, buying back their own stock, almost all through open-market repurchases. Dividends absorbed an additional 37% of earnings. Scant profits remained for investment in productive capabilities or higher incomes for hard-working, loyal employees.

Large-scale open-market repurchases can give a manipulative boost to a company's stock price. Prime beneficiaries of stock-price increases are the very executives who decide the timing and amount of buybacks to be done. In 2012 the 500 highest paid executives named on proxy statements averaged remuneration of \$24.4 million, with 52% coming from stock options and another 26% from stock awards. With ample stock-based pay, top corporate executives can gain from boosts in stock prices even when for most of the population economic progress is hard to find. If the United States is to achieve economic growth with an equitable income distribution and stable employment opportunities, government rule-makers and business decision-makers must take steps to bring both executive pay and stock buybacks under control.

From “retain-and-reinvest” to “downsize-and-distribute”

Now, as was the case a century ago, large corporations dominate the U.S. economy. In 2012 the top 500 U.S. business corporations by revenue had \$12.1 trillion in sales, \$804 million in profits, and 26.4 million employees worldwide.¹ How the executives of these companies decide to allocate resources has a preponderant

¹ Data available at http://money.cnn.com/magazines/fortune/fortune500/2013/full_list/. See also United States Census Bureau, “Statistics about Business Size” Table 2b. Employment Size of Employer and Non-Employer Firms, 2007, at <http://www.census.gov/econ/smallbus.html>. In 2007, 1,927 firms with 5,000 or more employees within one state and an average statewide workforce of just over 20,000 were only 0.03% of all employer firms, but they had 43% of revenues, 36% of payrolls, and 33% of employees. Note that these data on firm size are at the state level so that the concentration of revenues, payrolls, and employees among nation-wide enterprises was even greater. On the history of the large-scale U.S. industrial corporation, the classic work is Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business*, Harvard University Press, 1977. See William Lazonick, “Alfred Chandler’s Managerial Revolution: Developing and Utilizing Productive Resources,” in Morgen Witzel and Malcolm Warner, eds., *The Oxford Handbook of Management Theorists*, Oxford University Press: 361-384.

influence on the productive capability of the economy and the distribution of the gains of economic growth among the labor force.

In the post-World War II decades, the guiding principles of corporate resource allocation can be summed up as “retain-and-reinvest”.² Business corporations retained earnings and reinvested them in productive capabilities, including first and foremost those of employees who, in helping to make the enterprise more productive and competitive, benefited in the form of higher incomes and more employment security. “Retain-and-reinvest” is a resource-allocation regime that supports *value creation* at the business level and implements a process of *value extraction* through which the firm shares the gains of innovative enterprise with a broad base of employees. In doing so, the innovative enterprise can contribute to equitable and stable growth – or what I call “sustainable prosperity” – in the economy as a whole.³

Figure 1a below shows that until the late 1970s changes in real wages tracked changes in productivity in the U.S. economy. It was the retain-and-reinvest employment policies of major U.S. corporations that largely accounted for this result.⁴ In line with this movement, there was a trend toward greater income equality in the United States from the late 1940s well into the 1970s.

As shown in Figure 1b, however, since the late 1970s there has been a widening gap between the growth in productivity and the growth in real wages. This gap, I would argue, is largely the result of a shift of corporate resource allocation to a “downsize-and-distribute” regime in which corporate executives look for opportunities to downsize the labor force and distribute earnings to financial interests. Had corporate executives made different allocation decisions, some of the earnings that were paid out to shareholders could have been invested in, among other things, the productive capabilities of the people thrown out of work. Downsize-and-distribute is a resource-allocation regime that supports *value extraction* at the business level that may enrich financial interests at the expense of employees who contributed to the process of *value creation* that generated those earnings. As a result, a downsize-and-distribute allocation regime contributes to employment instability and income inequity.⁵

² William Lazonick and Mary O’Sullivan, “Maximizing Shareholder Value: A New Ideology for Corporate Governance” *Economy and Society*, 29, 1, 2009: 13-35.

³ William Lazonick, *Sustainable Prosperity in Economy in the New Economy? Business Organization and High-Tech Employment in the United States* (Upjohn Institute for Employment Research, 2009).

⁴ *Ibid.*, ch. 3.

⁵ William Lazonick and Mariana Mazzucato, “The Risk-Reward Nexus in the Innovation-Inequality Relationship,” *Industrial and Corporate Change*, 22, 4, 2013: 1093-1128

Figure 1a. Cumulative annual percent changes in productivity and real wages in the United States, 1948-1983

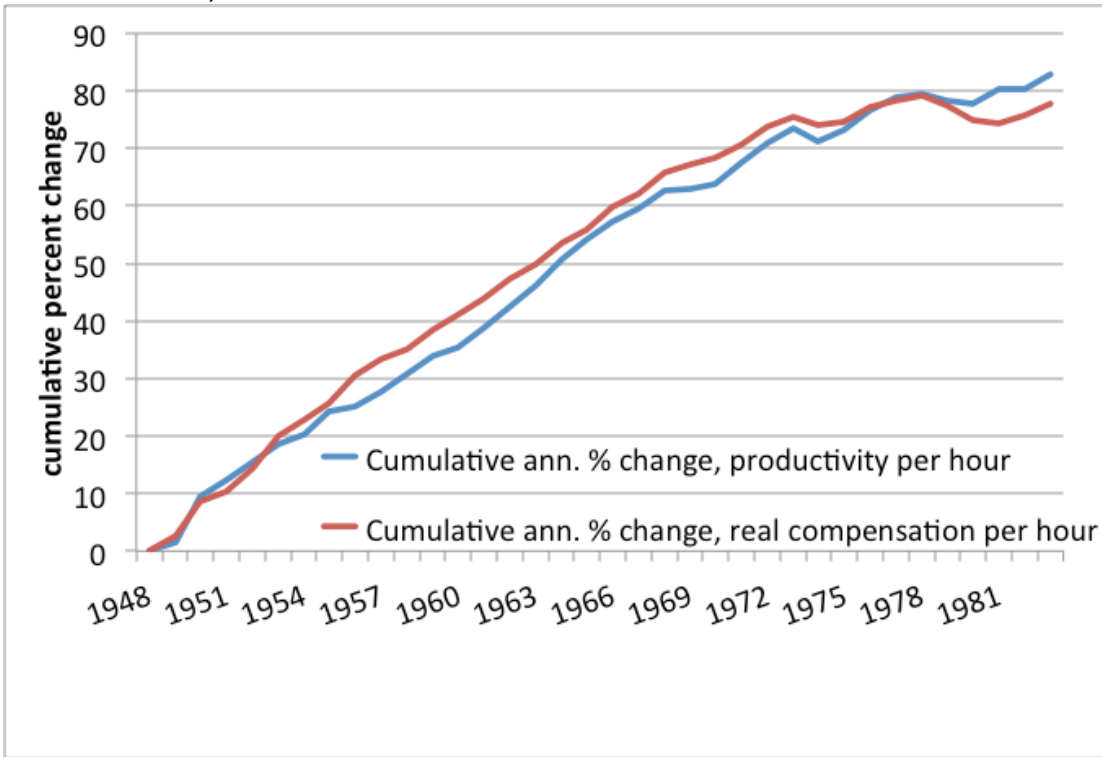
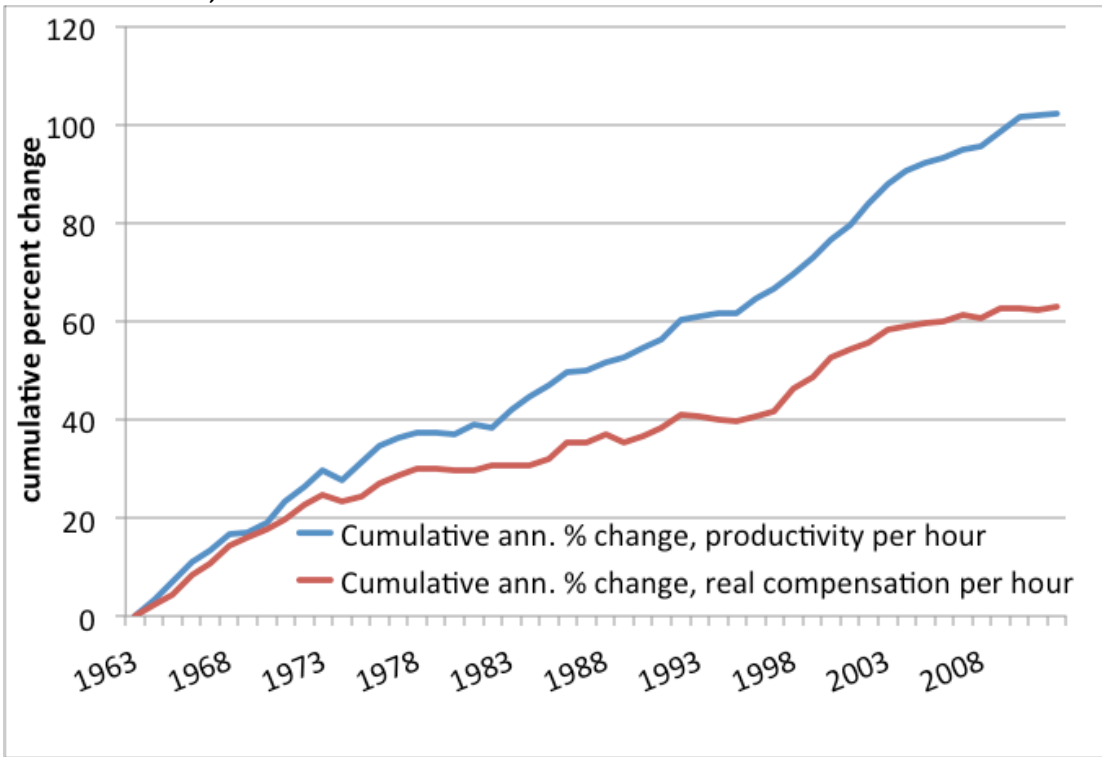


Figure 1b. Cumulative annual percent changes in productivity and real wages in the United States, 1963-2012



Source: <http://www.econdataus.com/wagegap12.html>

Since the beginning of the 1980s there have been three broad reasons for downsizing, which I summarize as “rationalization”, “marketization”, and “globalization”.⁶ From the early 1980s, rationalization, characterized by permanent plant closings, eliminated the jobs of unionized blue-collar workers. From the early 1990s, marketization, characterized by the end of a career with one company as an employment norm that had prevailed at major U.S. corporations through the 1980s, placed the job security of middle-aged and older white-collar workers in jeopardy. From the early 2000s, globalization, characterized by the massive movement of employment offshore, left all members of the U.S. labor force, even those with advanced educational credentials and substantial work experience, vulnerable to displacement.

Initially, each of these structural transformations in employment relations could be justified as resource-allocation responses to major changes in industrial conditions related to technologies, markets, and competition. During the onset of rationalization in the early 1980s, the plant closings were a response to the superior productive capabilities of Japanese competitors in consumer durable and related capital goods industries that employed significant numbers of unionized blue-collar workers. During the onset of marketization in the early 1990s, the erosion of the one-company-career norm among white-collar workers was a response to the dramatic technological shift of the microelectronics revolution from proprietary systems to open systems that favored younger workers with, for example, the latest programming skills. And during the onset of globalization in the early 2000s, the acceleration in the offshoring of the jobs was a response to the emergence of large supplies of highly capable but lower-wage labor in developing nations such as China and India whose work in tasks that had become routine complemented the expansion of higher-value added work being done by labor in the United States.

Once US corporations adopted these structural changes in employment, however, they often pursued these downsizing strategies purely for financial gain. Some companies closed manufacturing plants, terminated experienced (and generally more expensive) workers, and offshored production to low-wage areas of the world simply to increase profits, often at the expense of the companies’ long-term competitive capabilities and without regard for displaced employees’ long years of service. Moreover, as these changes became embedded in the structure of U.S. employment, business corporations failed to invest in new, higher-value-added job creation on a sufficient scale to provide a foundation for equitable and stable growth in the U.S. economy as a whole.

To the contrary, with superior corporate performance defined as meeting Wall Street’s expectations for 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 job creation in the U.S. economy over the past three decades have instead been used to buy back stock

⁶ Lazonick, *supra*, note 3., chs. 3-6; 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.

for the purpose of manipulating the company's stock price. Through their stock-based compensation, corporate executives who make these decisions are themselves beneficiaries of this focus on EPS and rising stock prices as the measures of corporate performance.

Dividends, not buybacks, are the traditional mode of distributing corporate cash to shareholders. Until the 1980s academics, executives, and regulators debated what proportion of profits could be paid out as dividends while leaving sufficient retained earnings to fund the growth of the firm.⁷ Retained earnings could be used for investment in plant and equipment, R&D, and training of the labor force as well as higher pay, more stable employment, and better working conditions for employees – all of which had the potential to generate sufficient productivity gains so that over time these expenditures could actually augment the company's profits.

During the 1980s, the retain-and-reinvest mode of resource allocation came under attack through the Reagan-era deregulation, the hostile takeover movement, and the newfound ideology of “maximizing shareholder value” (MSV). Embracing this new agenda, by the last half of the 1980s U.S. corporate executives became focused on using repurchases, in addition to dividends, as an important mode of distributing corporate profits to shareholders. Downsize-and-distribute became touted as an efficient mode of corporate resource allocation.

Dividends provide shareholders with a yield for, as the name says, *holding* stock. In contrast, buybacks provide shareholders with a yield for selling stock; that is, for ceasing to be shareholders. Since the 1980s, the ratio of dividends to net income for all U.S. corporations rose from 37% in both the 1960s and 1970s to 46% in the 1980s to 58% in the 1990s to 63% in the 2000s.⁸

Figure 2 shows net equity issues of U.S. corporations from 1946 to 2013. Net equity issues are new corporate stock issues minus outstanding stock retired through stock repurchases and M&A activity. Since the mid-1980s in aggregate, corporations have funded the stock market rather than vice versa.⁹ Over the past decade net equity issues of non-financial corporations averaged -\$376 billion per year.

That buybacks are largely responsible for negative net equity issues is clear from the chart on the evolution of gross repurchases shown in Figure 3. For the 251

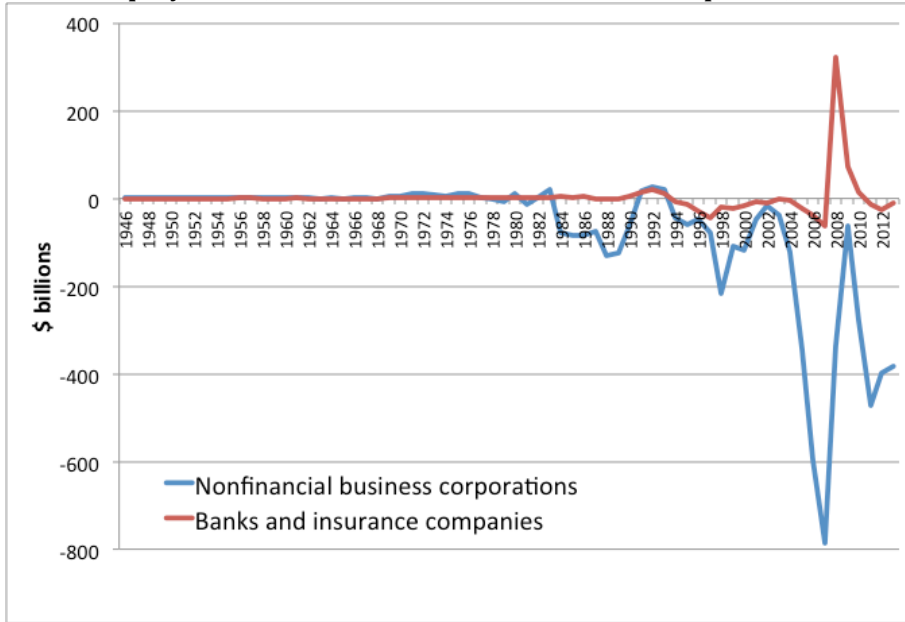
⁷ See, for example, the final speech of Harold Williams as chairman of the Securities and Exchange Commission before resigning his position in view of the election of Ronald Reagan to the U.S. Presidency. Harold M. Williams, “The Corporation as Continuing Enterprise,” address delivered to the Securities Regulation Institute, San Diego, California, January 21, 1981, at www.sec.gov/news/speech/1981/012281williams.pdf. Williams had previously been a corporate lawyer, business executive, and dean of the UCLA business school.

⁸ Federal Reserve Bank of St. Louis, *Federal Reserve Economic Data*, “Corporate Profits after tax with IVA and CCAAdj: Net Dividends (DIVIDEND)” at <http://research.stlouisfed.org/fred2/series/DIVIDEND>.

⁹ The spike in equity issues for financial corporations in 2009 occurred when they sold stock to the US government in the bailout. These banks that were bailed out had been major repurchasers of their stock in the years before the financial meltdown. See William Lazonick, “Everyone is Paying the Price for Share Buy-Backs” *Financial Times*, September 26, 2008, p. 25; William Lazonick, “The Buyback Boondoggle,” *BusinessWeek*, August 24 & 31, 2009, p. 96.

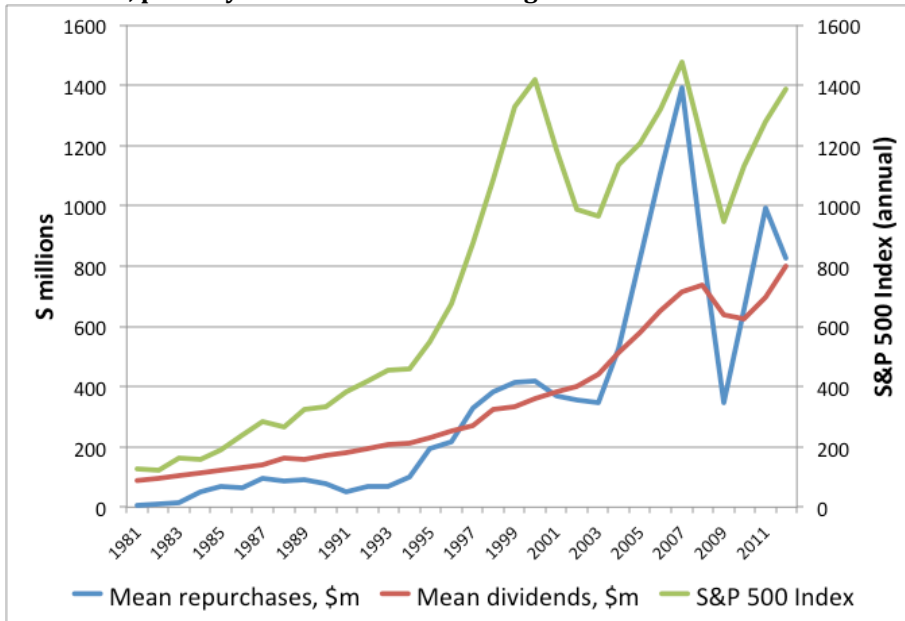
companies in the S&P 500 Index in January 2013 that were publicly listed back to 1981, the buyback payout ratio – that is, repurchases as a proportion of net income – was less than 5% in 1981-1983 but 39% in 2010-2012, with a three-year peak of 70% in 2006-2008. From the 1980s to the 1990s to the 2000s, the dividend payout ratio declined from 50% to 44% to 41%, while the buyback payout ratio rose from 22% to 35% to 50%.

Figure 2. Net equity issues, U.S. nonfinancial and financial companies, 1980-2013



Source: Federal Reserve Flow of Funds data, F-213, "Corporate Equities", March 6, 2014

Figure 3. Mean stock repurchases (RP) and cash dividends (DV) in 2012 dollars and as percentages of net income (NI), 251 companies in the S&P 500 Index in January 2013, publicly listed from 1981 through 2012



Source: Standard and Poor's Compustat database, corrected from 10-K filings by Mustafa Erdem Sakinç of The Academic-Industry Research Network.

Note in Figure 3 that buybacks increase in a rising stock market, as was especially the case in the decade 2003-2012. This fact undermines one of the most oft-cited justifications for buybacks, namely that companies do them when their top executives view the stock as undervalued by the market. In 1999, at the peak of the New Economy boom, Berkshire Hathaway CEO Chairman Warren Buffett warned in his letter to shareholders that “repurchases are all the rage, but are all too often made for an unstated and, in our view, ignoble reason: to pump or support the stock price.”¹⁰

The vast majority of buybacks done since the mid-1980s have been open-market repurchases in which neither shareholders nor the Securities and Exchange Commission (SEC), the federal government agency that is supposed to regulate the stock market, know the actual days on which top corporate executives have decided to repurchase the company’s stock. In his 1999 letter to shareholders, Buffett argued that buybacks could be beneficial to the “continuing shareholder” when done at below “intrinsic value”, when all shareholders “have been supplied all the information they need for estimating that value”. These types of repurchases are done as tender offers in which the company announces its intention to repurchase shares at a stipulated price. With the open-market repurchases that have predominated since the mid-1980s, however, only the top executives of the repurchasing company know the timing of the buybacks, creating the possibility that they might trade for their own benefit on this valuable inside information.

The government regulator encourages market manipulation

On November 17, 1982, the SEC promulgated Rule 10b-18, which gives a company a safe harbor against manipulation charges in doing open-market repurchases.¹¹ The safe harbor states that a company will not be charged with manipulation if its buybacks on any single day are no more than 25% of the previous four weeks’ average daily trading volume (ADTV). Under Rule 10b-18, moreover, there is no presumption of manipulation should the corporation’s repurchases exceed the 25% ADTV limit.¹²

Rule 10b-18 covers only open-market repurchases, which have been estimated to be as much as 90% of all buybacks, because it is in the open market that undetected stock-price manipulation can most easily occur. Private, off-market transactions such as tender offers are not regulated under the Rule. In 1982 the SEC also excluded “block trades” (at or above \$200,000 in value or numbering at least 5,000 shares with a minimum value of \$50,000) from the 25% ADTV calculation,

¹⁰ Letter to the shareholders of Berkshire Hathaway, Inc., at <http://www.berkshirehathaway.com/letters/1999.html>.

¹¹ Securities and Exchange Commission, “Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor,” November 17, 1982, *Federal Register*, Rules and Regulations, 47, 228, November 26, 1982: 53333-53341.

¹² <http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm>. For the safe harbor to be in effect, Rule 10b-18 also requires that the company refrain from doing buybacks at the beginning and end of the trading day, and that it do all the buybacks through one broker only.

apparently because in the early 1980s block trades, although done on the open market, were viewed as exceptional. In a revision of Rule 10b-18 in 2003, however, the SEC included most block trades in the 25% ADTV calculation.¹³

Rule 10b-18 requires companies to announce stock repurchase *programs* that have been approved by the board of directors. But it does not require disclosure of the particular days on which top corporate executives instruct the company's broker to execute *actual buybacks*. In its lack of disclosure, its 25% safe harbor limit, and the absence of a presumption of manipulation even when the 25% limit is exceeded, Rule 10b-18 is highly permissive of stock buybacks.

In a 1984 article, "Issuer Repurchases", Lloyd H. Feller, a former associate director of the SEC's Division of Market Regulation, and Mary Chamberlin, the then-current deputy chief counsel of that Division, called Rule 10b-18 a "regulatory about-face" from previous SEC views on the detection and prevention of manipulation through open-market repurchases.¹⁴ Since the SEC's inception as a result of the Securities Exchange Act of 1934, the regulatory agency had sought to prevent stock-price manipulation by insiders and to require companies to disclose all material information to all stock-market investors. In 1955 the SEC adopted Rule 10b-6 to try to prevent an issuing company from manipulating its stock-price during a *distribution* of its stock, such as during a public stock offering or an M&A deal, or when it had convertible bonds or warrants outstanding. In the 1960s, the "go-go years" of conglomeration and takeovers,¹⁵ the SEC sought to extend this anti-manipulative regulation to open-market repurchases more generally, and not just when a company had a distribution in process.

The result was Rule 13e-2, which emerged out of the Williams Act of 1968 (amending the Securities Exchange Act to require disclosure of information in cash tender offers) and made its first appearance in 1969. Rule 13e-2 was proposed, but never passed in 1970, 1973, and 1980. Rule 13e-2 emphasized disclosure of full information to investors to maintain the integrity of the stock market. In sharp contrast to Rule 10b-18, which in the "regulatory about-face" was adopted in 1982, Rule 13e-2 would have put a 15% ADTV limit on open-market repurchases, required disclosure of the days on which buybacks were actually done, and have presumed that a company was manipulating the market if it exceeded the 15% ADTV limit. Whereas Rule 13e-2 proposed strong regulation of stock-price

¹³ Securities and Exchange Commission, "Purchases of Certain Equity Securities by the Issuer and Others," (November 10, 2003), *Federal Register*, Rules and Regulations, 68, 221, November 17, 2003: 64952-64976. In response to comments on the proposed amendments to Rule 10b-18 that expressed concern that the elimination of the block exception would have an adverse impact on issuers with moderate or low ADTV that relied mainly on block purchases to implement their repurchase programs, the SEC amendment permitted a company to do one block trade per week that would remain an exception to the 25% ADTV calculation so long as no other repurchases were made on that day.

¹⁴ Lloyd H. Feller and Mary Chamberlin, "Issuer Repurchases," *Review of Securities Regulation*, 17, 1, 1984: 993-998.

¹⁵ John Brooks, *The Go-Go Years*, Weybright and Talley, 1973.

manipulation, Rule 10b-18 in effect gave corporations license to use open-market repurchases to manipulate the market.¹⁶

This regulatory reversal was the result of the 1980 election of Ronald Reagan as U.S. President on a platform of government deregulation and his appointment in 1981 of John Shad, vice-chairman of the stock brokerage firm E. F. Hutton, to head the SEC. Shad had been the first Wall Street executive to back Reagan for President, and had served as head of fundraising in New York State for the Reagan campaign.¹⁷ Not since Joseph Kennedy had been the inaugural chair of the SEC in 1934-35 had a Wall Street executive led the agency.

A *Wall Street Journal* article on the adoption of Rule 10b-18 noted that “[t]he new, deregulation-minded commission, with its 3-2 majority of Reagan appointees, has been revamping many SEC policies.” It went on to say that Shad hoped that buybacks would help to fuel increases in stock prices, and thus be beneficial to shareholders. The longest-serving SEC commissioner, John Evans, appointed by President Nixon in 1973, expressed concern that Rule 10b-18 represented deregulation of buybacks that could result in market manipulation.¹⁸ In the end, however, Evans agreed to make the adoption of Rule 10b-18 unanimous.

The 2003 amendment to Rule 10b-18 included block trades within the 25% safe harbor because, as the SEC stated in its release, “during the late 1990s, it was reported that many companies were spending more than half their net income on massive buyback programs that were intended to boost share prices – often supporting their share price at levels far above where they would otherwise trade.” The SEC went on to warn that the unregulated use of block trades in doing buybacks could exacerbate “the potential for manipulative abuse”, and “mislead investors about the integrity of the securities trading market as an independent pricing mechanism.”

In seeking to rectify these problems, the 2003 amendment to Rule 10b-18 initiated quarterly reports on stock buybacks. But the SEC still did not require disclosure of the actual days on which buybacks were done so it could determine, without a special investigation, whether a company had in fact exceeded the 25% ADTV safe harbor limit. And, given the escalation of buybacks after 2003, it is clear that the 2003 amendment did nothing to bring “the potential for manipulative abuse” under control. For the 251 major U.S. corporations included in Figure 2 above, the repurchase payout ratio for 2005 through 2008 was 64%, far higher than the 45% it had been in 1997 through 2000, a period in which the SEC had viewed buybacks as possibly contributing to market manipulation. Compared with 1997-2000, the absolute value of buybacks in inflation-adjusted dollars was 2.2 times higher in

¹⁶ See Douglas O. Cook, Laurie Krigman, and J. Chris Leach, “An Analysis of SEC Guidelines for Executing Open Market Repurchases,” *Journal of Business*, 76, 2, 2003: 289-315.

¹⁷ See Jeff Gerth, “Shad of S.E.C. favors bright corporate image,” *New York Times*, August 3, 1981, p. D1.

¹⁸ Richard L. Hudson, “SEC eases way for repurchase of firms’ stock,” *Wall Street Journal*, November 10, 1982, p. 2.

2005-2008 and 1.4 times higher in 2009-2012, a four-year period that includes the sharp fall in buybacks in 2009 as a result of the financial crisis.

The daily buybacks that are permissible within the 25% ADTV limit are sufficiently large to permit a company to manipulate its own stock price. Table 1 shows the top ten stock repurchasers for 2003-2012, and the proportions of net income that each company spent on buybacks and dividends over the decade. In most cases, total distributions to shareholders exceeded net income.

Table 1. Repurchases (RP) and dividends (DV) as percentages of net income (NI), ten largest repurchasers for the decade 2003-2012

Company Name	NI \$b	RP \$b	DV \$b	%RP/NI	%DV/NI	%(RP+DV)/NI
EXXON MOBIL	347	207	80	60	23	83
MICROSOFT	148	114	71	77	48	125
IBM	117	107	23	91	20	111
CISCO SYSTEMS	64	75	2	118	3	121
PROCTER & GAMBLE	93	66	42	71	46	116
HEWLETT-PACKARD	41	64	9	155	21	177
WAL-MART STORES	134	62	35	46	27	73
INTEL	79	60	27	76	34	109
PFIZER	84	59	63	71	75	146
GENERAL ELECTRIC	165	45	87	28	53	81

Source: Standard and Poor's Compustat database, corrected from company 10-K filings by Mustafa Erdem Sakinç, The Academic-Industry Research Network.

Assuming that block trades are included in the ADTV calculations, under Rule 10b-18 on January 10, 2014, Exxon Mobil, by far the biggest stock repurchaser with \$207 billion in the decade 2003-2012, could buy back up to \$315 million worth of shares per day without fear of facing manipulation charges. The daily buyback safe-harbor limits for the next nine top repurchasers for 2003-2012 ranged from \$87 million for Hewlett-Packard to \$309 million for Microsoft. Apple Inc., which did \$22.9 billion in buybacks in fiscal 2013, after having largely refrained from the practice during the reign of Steve Jobs, can, at the time of writing, do up to \$1.5 billion per day while still availing itself of the safe harbor. Within the limits of the total value of buybacks set by a board-authorized repurchase program, Rule 10b-18 permits buybacks of these manipulative magnitudes to be repeated trading day after trading day.

Why do companies do buybacks?

The reasons commonly given to justify open-market repurchases all defy facts and logic. As already mentioned, executives often claim that buybacks are financial investments in undervalued shares that signal confidence in the company's future as measured by its stock-price performance. But as we have seen, over the past two decades major US companies have tended to do buybacks in bull markets and cut back on them, often sharply, in bear markets.

Indeed, our research shows that companies that do buybacks never sell the shares at higher prices so that the corporation can cash in on these investments. To do so would be to signal to the market that the company's stock price had peaked, which no CFO would want to do. On the contrary, a company that has sold high in a boom is sometimes forced to sell low in a bust to alleviate financial distress. For example, in the first three quarters of 2008 General Electric spent \$3.2 billion on buybacks at an average price per share of \$31.84. Then, to protect its triple-A credit rating in the wake of the losses of GE Capital in the financial crisis, the company did a \$12.0 billion stock issue in the last quarter of 2008 at an average price per share of \$22.25.

Another argument for doing buybacks is that a mature company runs out of profitable investment opportunities, so it is time to return cash to shareholders. The first problem with this argument is that, typically, the shareholders to whom cash is being "returned" never made investments in the value-creating assets of the company in the first place. For example, the only money that Apple Inc. has ever raised from public shareholders was \$97 million at its IPO in 1980.¹⁹ Recently, hedge-fund activists such as David Einhorn and Carl Icahn, who have invested no money in Apple's productive assets and have played absolutely no role in the company's success, have purchased large stakes on the stock market and have pressured the company to "unlock value" for shareholders by doing the largest buyback programs in corporate history.

The second problem with the "mature company" argument for doing buybacks is that companies that have over decades accumulated productive capabilities typically have enormous organizational and financial advantages, known as "dynamic capabilities", for entering related product markets, either by setting up new divisions or spinning off new firms.²⁰ The strategic function of top executives is to discover new opportunities for the productive use of these dynamic capabilities. When instead they opt to do large-scale open-market repurchases, these executives are in effect *not* doing their jobs.

A commonly stated reason for doing buybacks is to offset dilution of EPS when employees exercise stock options that are part of their compensation. As I have documented, the volume of open-market repurchases is generally a multiple of the volume of options that employees exercise.²¹ In any case, there is no logical economic rationale for doing repurchases to offset dilution from the exercise of employee stock options. The point of this mode of compensation is *to motivate employees to work harder and smarter now for the sake of higher returns to the company in the future*. Corporate executives should be willing to wait for higher EPS to materialize in the future as a result of employee work effort rather than use

¹⁹ William Lazonick, Mariana Mazzucato and Öner Tulum, "Apple's Changing Business Model: What Should the World's Richest Company Do With All Those Profits?" *Accounting Forum*, 37, 4, 2013: 249-267.

²⁰ David J. Teece, *Dynamic Capabilities and Strategic Management: Organizing for Innovation and Growth*, Oxford University Press, second edition, 2011.

²¹ William Lazonick, "The New Economy Business Model and the Crisis of US Capitalism," *Capitalism and Society*, 4, 2, 2009: article 4, p. 43.

corporate cash to offset dilution to guarantee higher EPS right away. And if higher earnings do appear, the employees should gain by exercising their options, while the company can allocate the increased earnings to investment in the next round of innovation.

Finally, there is the argument put forward by agency theorists, most notably Michael C. Jensen, that says that public shareholders are the economic actors who are best positioned to allocate productive resources to their best alternative uses.²² But as I have shown in my work, this argument lacks a theory of the commitment of financial resources to innovative investment strategies.²³ Retained earnings have always been the foundation for investment in innovation, the essence of which is collective and cumulative learning within business organizations. The argument that buybacks represent “free cash flow”, as agency theorists contend, is typically an excuse for avoiding investments in innovation.

More than that, the theory that economic efficiency requires that corporate executives allocate resources to “maximize shareholder value” (MSV) is fundamentally flawed. The argument for MSV assumes that shareholders are the only participants in the economy who bear risk by investing in the economy without a guaranteed return. Not so. *Taxpayers* through government agencies that invest in infrastructure and knowledge-creation and *workers* through the firms that employ them to engage in collective and cumulative learning make risky investments in productive capabilities on a regular basis, without guaranteed returns.²⁴ As risk bearers, taxpayers whose dollars support business enterprises and workers whose efforts generate productivity improvements have claims on corporate profits if and when they occur. The irony of MSV is that the public shareholders whom agency theory holds up as the economy’s only risk-bearers typically never invest in the value-creating capabilities of the company at all. Rather they invest in outstanding shares in the hope that they will rise in price on the market. And, following the directives of MSV, a prime way in which corporate executives fuel this hope is by doing large-scale buybacks to manipulate the market.

The more one delves into the reasons for the huge increase in open-market repurchases since the mid-1980s, the clearer it becomes that the only plausible reason for this mode of resource allocation is that the very executives who make the buyback decisions have much to gain personally through their stock-based pay. For the decade 2003-2012, during which the ten largest repurchasers in Table 1

²² Michael C. Jensen, “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers” *American Economic Review* 76, 2, 1986 323-329.

²³ William Lazonick, “The Chandlerian Corporation and the Theory of Innovative Enterprise,” *Industrial and Corporate Change*, 19, 2, 2010: 317-349; William Lazonick, “Innovative Enterprise and Shareholder Value,” *Law and Financial Markets Review*, 8, 1, 2014: 52-64. These critiques of agency theory build on arguments that I was making in the late 1980s and early 1990s. See William Lazonick, “Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism,” *Industrial and Corporate Change*, 1, 3, 1992: 445-488. See also Lynn Stout, *The Shareholder Value Myth*, Berrett-Koehler Publishers, 2012.

²⁴ Lazonick, “Innovative Enterprise and Shareholder Value”, *supra*, note 23.

above did a combined \$859 billion in buybacks, equal to 68% of their net income, the CEOs of these companies received an average of \$152 million in compensation (ranging from \$14 million at Microsoft to \$329 million at Cisco), of which 24% was from stock options and 36% from stock awards. During this decade the other four highest paid at these ten companies received an average of \$95 million in compensation, of which 25% came from stock options and 36% from stock awards. Meanwhile since 2003 the stock prices of only three of the ten largest repurchasers, Exxon Mobil, IBM, and Procter and Gamble, have outperformed the S&P 500 Index.

Maximizing executive compensation

In its release on the amendment to Rule 10b-18 in 2003, the SEC articulated clearly why it needs to get rid of Rule 10b-18. “In summary,” wrote the SEC, “Rule 10b-18 is intended to protect issuer repurchases from manipulation charges when the issuer has no special incentive to interfere with the ordinary forces of supply and demand affecting its stock price. Therefore, it is not appropriate for the safe harbor to be available when the issuer has a heightened incentive to manipulate its share price.”²⁵

Yet the stock-based pay of the executives who decide to do repurchases on any given day provides the issuer with “a heightened incentive to manipulate its share price.” As shown in Figure 4, from 1992 through 2012 for the 500 highest paid corporate executives named on proxy statements anywhere from 55% to 86% of their total remuneration was stock-based, mainly in the form of gains from exercising stock options but increasingly in the form of restricted stock awards that require the company to attain EPS targets.

Given the fact that in the United States companies are not required to announce the dates on which they actually do open-market repurchases, there is an opportunity for top executives to do buybacks to benefit themselves. Buybacks can enable companies to hit quarterly EPS targets, with the manipulation invisible to the public. The manipulation of EPS can make executives look good to Wall Street, in some cases offsetting EPS declines that reflect “bad news”.²⁶ And it can also directly pad their pay, as is often the case with restricted stock awards that are contingent on EPS performance.²⁷

Moreover, top executives who are privy to the company’s repurchasing activity can use this inside information to time their option exercises and stock sales to increase their pay. Indeed, in 1991 the SEC made it easier for top executives to do just that. Until 1991, Section 16(b) of the 1934 Securities Exchange Act prevented top executives from reaping short-swing profits when they exercised their stock

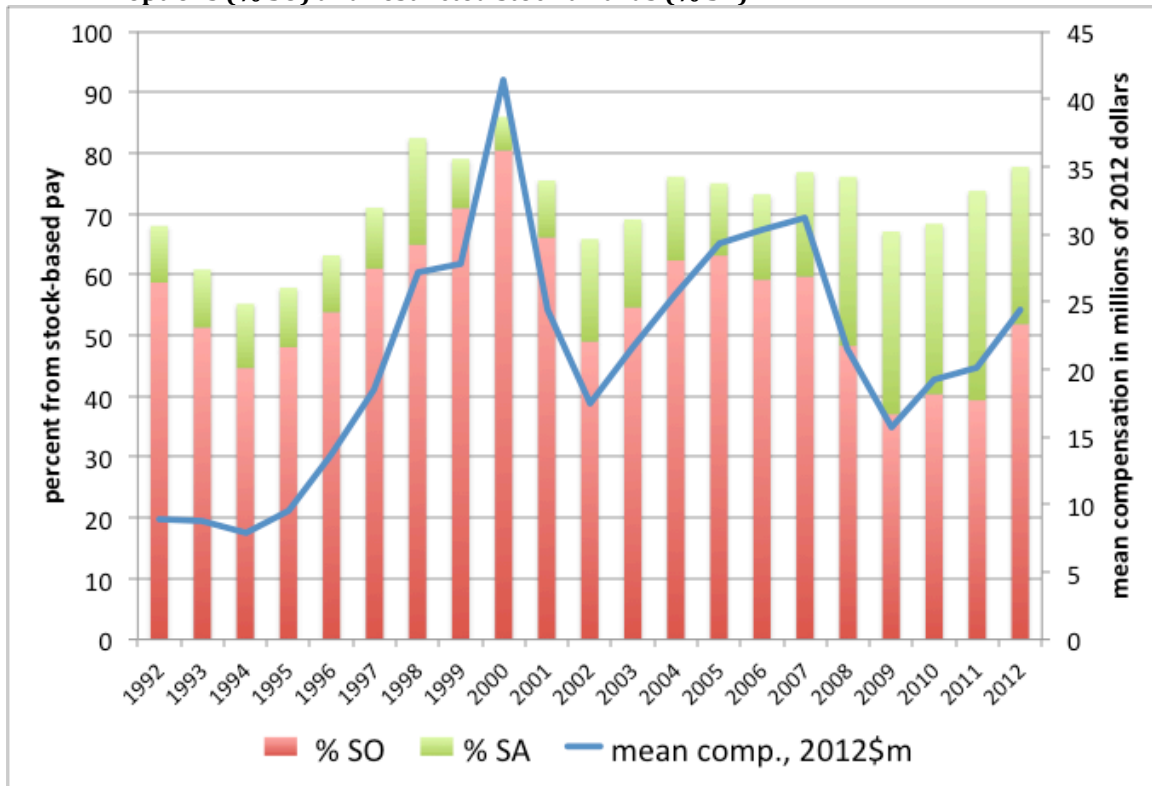
²⁵ SEC, *supra*, note 13, p. 64953.

²⁶ See Lazonick, “Financialization,” *supra* note 6, p. 897, for the case of Amgen in 2007.

²⁷ See for example Paul Hribar, Nicole Thorne Jenkins, and W. Bruce Johnson, “Repurchases as a Earnings Management Device,” *Journal of Accounting and Economics*, 41, 1-2, 2006: 3-27; Steven Young and Jing Yang, “Stock Repurchases and Executive Compensation Contract Design: The Role of Earnings per Share Performance Conditions,” *The Accounting Review*, 86, 2, 2011: 703-33.

options by requiring that they wait at least six months before selling the acquired shares. In 1991, by arguing that a stock option is a derivative, the SEC determined that henceforth the six-month waiting period would begin at the grant date, not the exercise date. Since the option grant date is always at least one year before the option exercise date, this reinterpretation of Section 16(b) meant that top executives, as company insiders, could now sell the shares acquired from stock options immediately upon exercise.

Figure 4. Mean total compensation of the 500 highest paid executives named on U.S. company proxy statements, and the percentages of the total derived from exercising stock options (% SO) and restricted stock awards (% SA)



Source: Standard and Poor's Execucomp database, with calculations by Matt Hopkins, The Academic-Industry Research Network.

With this reinterpretation pending in 1989, a Towers Perrin consultant told the *New York Times*, the change was “great news for executives because they give insiders much more flexibility in buying and selling stock.” The same article noted that the proposed change to Section 16(b) “would provide a dual benefit. Since corporate insiders could immediately sell the stock, they could qualify for loans from brokers that would enable them to exercise stock options without laying out their own cash. They would also no longer face the risk that the shares might decline in value during the holding period.”²⁸ After the Section 16(b) reinterpretation went into effect in May 1991, a compensation consultant was

²⁸ Carole Gould, “Shaking up executive compensation,” *New York Times*, April 9, 1989, p. F13.

quoted as saying that senior executives “now have an opportunity of making a decision of when to get in and out at the most propitious time.”²⁹

Do top executives actually trade on this inside information? We do not know because the SEC does not require that, even after the fact, companies disclose the days on which they have done open-market repurchases. What we do know is that, to paraphrase a 1960 *Harvard Business Review* article,³⁰ executive compensation has gotten out of hand. Stock-based pay creates a strong incentive for corporate executives to orient themselves toward downsize-and-distribute rather than retain-and-reinvest. And since the 1980s downsize-and-distribute has been the clear-cut winner in the corporate resource-allocation game.

How to put a stop to the buyback binge

The problem is that corporate resource-allocation is not a game. It is our source of economic security or insecurity, as the case may be. If Americans want an economy in which corporate profits result in shared prosperity, the corporate buyback binge must be brought to an end. As with any addiction, the addicted will experience withdrawal pains. But the best corporate executives may actually derive considerable satisfaction from getting paid a reasonable salary for investing in their company’s future rather than, as is typically the case now, an enormously excessive salary for living off someone else’s past.

Given the huge sums of money involved, it will require a regulatory authority – the U.S. government – to step in to control the behavior of those who are unable or unwilling to control themselves. In the case of buybacks, the regulatory authority is the SEC. “The mission of the U.S. Securities and Exchange Commission”, we are told on its website,³¹ is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”³¹ Yet, as we have seen, in its rulings on, and monitoring of, stock buybacks and executive pay going back over three decades, the SEC has taken a course of action contrary to these objectives. It has assisted financial interests, including top corporate executives, in capturing the lion’s share of the gains of U.S. productivity growth while the vast majority of Americans have been left behind.³² The formulation of Rule 10b-18 and the interpretation of Section 16(b) have facilitated a rigged stock market while, by disgorging cash to shareholders, undermining capital formation, including, it must be stressed, *human* capital formation.

The American public should demand that the federal government agency that is supposed to regulate the stock market rescind the “safe harbor” that enables corporate executives to manipulate stock prices, secure in the knowledge that their actions are government tested and approved. More than that, let the SEC do a

²⁹ Jan M. Rosen, “New regulations on stock options,” *New York Times*, April 27, 1991, p. 38.

³⁰ Ervin N. Griswold, “Are Stock Options Getting Out of Hand?” *Harvard Business Review* 38, 6, 1960: 49–55.

³¹ <http://www.sec.gov/about/whatwedo.shtml>

³² Lazonick, *supra*, note 6.

Special Study, on the scale of its 1963 study of securities markets that resulted in the creation of NASDAQ,³³ of the possible damage that open-market repurchases have done to the U.S. economy over the past three decades. The fact that the SEC has facilitated, and even encouraged, a mode of resource allocation in which trillions of dollars of corporate profits have been thrown away on buybacks indicates that there is a pressing need for a major rethinking about how the stock market functions, and indeed what functions we expect it to perform.³⁴ The SEC may well be advised to make open-market repurchases illegal.

The American public should also demand that the SEC restore the prohibition that existed from 1934 to 1991 against top executives as insiders reaping short-swing profits. Although this piece of regulation would not in and of itself prevent U.S. corporate executives from reaping what they have not sown, it could help launch a much-needed discussion in the United States of the meaningful reform of executive compensation that goes beyond the ineffectual ceremony of the 2010 Dodd-Frank Act's "Say-on-Pay".³⁵

That discussion would take up the need for changes in the composition of boards to include representatives willing and able to take a stand against excessive executive pay. Boards are currently dominated by other CEOs who have a strong bias toward ratifying higher pay packages for their peers. There is a urgent need to rekindle the conversation started by Graef Crystal's 1991 best-seller, *In Search of Excess: The Overcompensation of the Corporate Executive*, in which this well-known compensation expert showed how, to give cozy boards cover to ratchet up executive pay, CEOs hired the same group of compensation consultants to benchmark the pay of other CEOs in their interlocking directorship network. As we have seen, top executive pay is now about three times greater in real terms than it was in the early 1990s when Crystal sounded the alarm on the overcompensation of the American executive.

In going beyond "Say-on-Pay", the U.S. Congress might show the courage and independence of its predecessors in standing up to corporate executives who had taken advantage of government regulation to pad their pockets.³⁶ In the Reform Act of 1950, corporate executives had been granted the right to be taxed at the 25% capital-gains rate when they exercised qualified stock options instead of at the personal-income rate, which on the top tax bracket was 91%. Subsequent to the 1960 publication of the *Harvard Business Review* article, "Are Stock Options Getting Out of Hand," by Harvard Law School Dean Ervin Griswold, Senator Albert Gore (D-Tennessee) launched a campaign through which Congress whittled away at the

³³ http://www.sechistorical.org/museum/galleries/tbi/special_a.php

³⁴ See Lazonick, *supra*, note 21.

³⁵ William Lazonick, "How GE and Jeff Immelt are failing to reinvigorate the U.S. economy," *The Globalist*, May 3, 2011, at <http://www.theglobalist.com/how-ge-and-jeff-immelt-are-failing-to-reinvigorate-the-u-s-economy/>

³⁶ The following history is recounted in William Lazonick, "The Explosion of Executive Pay and the Erosion of American Prosperity," *Entreprises et Histoire*, 57, 2009, pp. 151-154.

special tax advantages that had been accorded executive stock options.³⁷ After the Tax Reform Act of 1976, Graef Crystal was able to declare that stock options that qualified for the capital-gains tax rate, “once the most popular of all executive compensation devices,...have been given the last rites by Congress.”³⁸ It also happens that the 1970s was the period over the last century in which the share of the top 0.1% of households of all U.S. income was at its lowest.³⁹

Finally, in carrying out reforms of corporate resource allocation and executive pay, it must be recognized that in repurchasing stock and jacking up their own stock-based income, corporate executives have been doing exactly what agency theorists in leading business schools have been telling them to do: disgorge the so-called “free” cash flow and incentivize themselves to “maximize shareholder value” by gorging themselves on stock-based pay.⁴⁰ Yet, like neoclassical economic theory, from which it is derived, agency theory lacks a theory of innovative enterprise.⁴¹ It poses as a theory of value creation, when in fact it can only contemplate value extraction.

The deeper intellectual problem, as I have argued elsewhere, is the adherence of neoclassical economists, conservative and liberal alike, to the “myth of the market economy”.⁴² It is time for the economics profession to get serious about constructing a theory of the relation between resource allocation and economic performance that can comprehend the evolution and operation of the business corporation. Only then, in my view, can “new economic thinking” become a positive force in the quest for stable and equitable economic growth.

³⁷ Albert Gore, “How to be rich without paying taxes,” *New York Times Magazine*, April 11, 1965, pp. 28-29, 86.

³⁸ Graef S. Crystal, *Executive Compensation: Money, Motivation, and Imagination*, American Management Association, 1978, p. 145.

³⁹ See Anthony B. Atkinson, Thomas Piketty, and Emmanuel Saez, “Top Incomes in the Long Run of History,” *Journal of Economic Perspectives*, 49, 1, 2011, p. 8. For updates see <http://topincomes.parisschoolofeconomics.eu/#Country:United%20States>.

⁴⁰ Jensen, *supra*, note 22; Michael C. Jensen and Kevin J. Murphy, “Performance Pay and Top Management Incentives” *Journal of Political Economy* 98, 2, 1990: 225-264.

⁴¹ See *supra*, note 23.

⁴² William Lazonick, *Business Organization and the Myth of the Market Economy*, Cambridge University Press, 1991; William Lazonick, “The Theory of the Market Economy and the Social Foundations of Innovative Enterprise,” *Economic and Industrial Democracy*, 24, 1, 2003: 9-44; William Lazonick, “The Innovative Enterprise and the Developmental State: Organizational Foundations of Sustainable Prosperity,” *AIR Working Paper*, April 2014.