Shareholder capitalism on trial

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The latest rap against big corporations is that they’re returning too much money to shareholders through dividends and stock repurchases. What they should be doing, the complaint goes, is using that money to build new factories, create new products and increase research. Their stinginess, the argument continues, is one reason for the lackluster recovery. Worse, the stock buybacks are driven by executive greed. When companies buy their own stock, share prices tend to rise — a boon to top executives whose compensation packages are linked to higher prices.

Put simply, so-called shareholder capitalism is a flop. It serves the interests of rich executives and investors, not the larger public.

As with many economic indictments, this one has some truth — and much exaggeration. Let’s see why. It’s true that dividends and stock buybacks have become more popular. Among the companies in the Standard & Poor’s 500 index, dividends in 2014 totaled $350 billion and buybacks $553 billion, notes S&P’s Howard Silverblatt. The $903 billion total equals almost all of the S&P companies’ reported 2014 profits of $917 billion.

It’s also true that investment has been weak. The financial crisis resulted in about a 20 percent drop in U.S. investment spending, reports a new study from the Bank for International Settlements (BIS) in Switzerland. Firms canceled projects to save cash and because demand had weakened. Only last year did U.S. investment (adjusted for inflation) regain its 2007 peak. Many other countries, including France and Germany, remained below their 2007 peak, says the BIS study. Finally, many executives are enriched by higher share prices, because their stock options become more valuable.

Altogether, the evidence looks damning. Corporate chiefs skimmed on investment to line their pockets. Or so it seems. The trouble with this indictment is that it’s built on selective evidence. With more evidence, the case looks less compelling.

For starters, weak investment spending mostly reflects a “lack of profitable investment opportunities,” concludes the BIS study. The Great Recession depressed demand and created greater uncertainty. Companies are less willing to commit funds in this more hostile and less predictable climate. Nor have large payouts to shareholders left companies short of cash, unable to exploit otherwise-attractive investment projects. At year-end 2014, the S&P companies had an estimated $1.3 trillion in cash and short-term securities, more than double what they had in 2007, says Silverblatt.

Would we really be better off if firms bankrolled dubious projects that cranked out products for which there was little demand? Any initial boost to economic growth might be offset later as firms cut spending to minimize losses or restore profitability.
Similarly, most executives don’t automatically favor share purchases over hard investment projects, argues Harvard law professor Lucian Bebchuk, an expert on corporations. If they had hard projects that were more profitable than purchasing shares, they would actually do better personally, he says. Firms would become more profitable, so their stock prices and executive compensation would rise even further.

What’s happening, Bebchuk says, is that investment funds are being channeled from slow-growing to fast-growing sectors. That’s what capitalism is supposed to do: reallocate capital from firms that don’t need it to firms that do. Some companies buy back their stock, returning money to shareholders, while other companies raise money by selling new shares to stockholders. In 2013 and 2014, U.S. companies raised more than $300 billion by selling new shares, reports the BIS, but that figure is overshadowed by the larger volume of buybacks.

Finally, the sizable dividends and stock buybacks have also boosted the stock market, contributing to consumer confidence and spending — though how much is open to question.

The problem isn’t shareholder capitalism. It’s the hangover from the financial crisis and Great Recession. Consumers are spending less and saving more to protect themselves against future economic shocks; this cautiousness then makes businesses more defensive, curtailing major investment projects. The two feed on each other. It’s a vicious circle that has been hard to break.