THESE DAYS RATHER THAN saving its money to grow the business or increases the employee’s wages, the company gives back whatever money it has made in profits to its owners, or shareholders. A company can do this in two ways: paying dividends or buying back its stock. What is less well-known, however, is that a relatively small group of large U.S. blue chips — companies including Coca-Cola, McDonalds and IBM — has substantially increased the amount of cash it has returned to shareholders. In 2007, before the financial crisis, U.S. companies returned $673 billion in cash to shareholders, which represented 90 percent of aggregate corporate earnings. That’s a mind-boggling amount of money. About three-quarters of this amount is attributable to a small set of very large companies, which increasingly dominate the distribution of earnings and payouts.¹²

To “maximize” a company’s share price has no foundation in history or in law. Nor is there any empirical evidence that it makes the economy or the society better off. What began in the 1970s and ’80s as a useful corrective to self-satisfied managerial mediocrity has become a corrupting, self-interested dogma peddled by finance professors, money managers and over-compensated corporate executives. One can argue that much of what Americans perceive to be wrong with the economy these days — the slow growth and rising inequality; the recurring scandals;
the wild swings from boom to bust; the inadequate investment in R&D, worker training and public goods — has its roots in this ideology.  

The change can be seen in statements from IBM’s leaders over the years. Thomas J. Watson Jr., son of the company’s founder, IBM’s president and CEO, published a seminal text in 1963 called “A Business and Its Beliefs: The Ideas that Helped Build IBM.” In it, he wrote that IBM’s philosophy could be contained in three beliefs: One, the most important, was respect for the individual employee; the second, a commitment to customer service; and third, achieving excellence. He wrote that balancing profits between the well-being of employees and the nation’s interest is a necessary duty for companies. Watson took pride in the fact that his father avoided layoffs, even through the Great Depression. “We acknowledge our obligation as a business institution to help improve the quality of the society we are part of,” read the text of IBM’s corporate values. Under Watson’s watch, IBM introduced groundbreaking computers that shot his father’s company to the top of the technology world. On the other hand, in 2013 the then chief executive Virginia Rometty had pledged to follow a plan called the “2015 Road Map” in which the primary goal is to dramatically raise the company’s earnings-per-share figure, a metric favored by Wall Street.  

Similar was the perspective of Owen Young, who was CEO of GE almost straight through from 1922 to 1945: “Stockholders are confined to a maximum return equivalent to a risk premium. The remaining profit stays in the enterprise, is paid out in higher wages, or is passed on to the customer.” On the other hand, Jack Welch, CEO from 1981 to 2001, believed in “the shareholder as king—the residual claimant, entitled to the [whole] pot of earnings.”  

Since the World War II and till early 1970s, all the stakeholders (customers, employees, suppliers, shareholders and community) were nearly treated equally by the CEOs. With boards heavily stacked with insiders and salaries and cash bonuses the sole source of executive compensation, there was no linkage between changes in stock price and changes in executive pay. In 1970, for example,
stock-based compensation represented less than 1% of CEO remuneration.\(^46\)

During 1970s, shareholders were not getting the enough returns due to high oil price and high inflation which affected the profits of the US companies. The most likely explanations for the transformation to ‘Shareholder First’ are two broad structural changes — globalization and deregulation — which together conspired to rob many major American corporations of the outsize profits they had earned during the “golden” decades after World War II. Those profits were so generous that there was enough to satisfy nearly all the corporate stakeholders. But in the 1970s, when increased competition started to squeeze out profits, it was easier for executives to disappoint shareholders than their workers or communities. The result was a lost decade for investors. \(^47\)

In the 1970s, most public companies paid dividends, typically about 30 percent of earnings. In the early 1980s, a change in the securities laws allowed firms to buy their own shares for the first time, which led to the emergence of stock repurchases as an alternative way of returning cash to shareholders. Managers would buy back their stocks when they viewed them as cheap, and the stocks tended to outperform in the months after the buyback. \(^48\)

Lynn Stout, a professor of corporate and business law at Cornell University Law School, traces the transformation to the rise of the “Chicago school” of free-market economists. In 1970, Nobel Prize-winning economist Milton Friedman wrote an article in the *New York Times Magazine* in which he famously argued that the only “social responsibility of business is to increase its profits.” Then in 1976, economists Michael Jensen and William Meckling published a paper saying that shareholders were “principals” who hired executives and board members as “agents.” In other words, when you are an executive or corporate director, you work for the shareholders. \(^49\)

The Reagan Administration did several things that directly encouraged the merger movement of the 1980s. William Baxter, Reagan’s attorney general in charge of antitrust, had been an active opponent of the antitrust laws while a lawyer and academician. In
1981, he announced new merger guidelines. These guidelines committed the government to approving almost all mergers except those that led to concentration ratios within particular markets of greater than 80%. This gave the green light to all forms of mergers, large and small, vertical and horizontal. The Reagan Administration also substantially reduced corporate income taxes at the same time. Reagan encouraged firms to use this largesse to make new investments in the economy. The kind of investment that most of them made was mergers.\textsuperscript{50}

In 1981 John Shad, a Wall Street banker and Ronald Reagan backer, became head of the Securities and Exchange Commission (SEC). Shad, like the Chicago economists who influenced him, believed that a deregulated stock market was good for the economy. In November 1982, the very government agency that is supposed to regulate the stock market adopted Rule 10b-18, which instead encourages corporations to manipulate stock prices through open-market repurchases. Rule 10b-18 gives corporations a “safe harbor” against charges of stock-market manipulation if, among other things, its buybacks on any single day are no more than 25 percent of the previous four weeks’ average daily trading volume, which for many companies can be $200 million or more in buybacks per day. Only top executives know when buybacks are actually done, so if the corporation’s buybacks exceed the 25 percent limit it is not likely that there will be repercussions.\textsuperscript{51}

Together with new competition overseas, the pressure to respond to the short-term demands of Wall Street has paved the way for an economy in which companies are increasingly disconnected from the state of the nation, laying off workers in huge waves, keeping average wages low and threatening to move operations abroad in the face of regulations and taxes.\textsuperscript{52}

With changes in compensation strategy aimed at better aligning shareholder and executive interests, high stock prices also meant substantially larger financial reward—especially as companies turned to larger and larger stock awards and stock option grants. Not surprisingly, executives once fearful of the change in alignment not only saw the personal financial benefits, but then
sought to maximize them. More powerfully, it helped spawn the rise of executive pay tied to share prices — and thus the huge rise in stock-option pay. As a result, average annual executive pay has quadrupled since the early 1970s.\(^5^3\)

Roger Martin, the outgoing dean of the Rotman School of Management at the University of Toronto, calculates that from 1932 until 1976 — roughly speaking, the era of “managerial capitalism” in which managers sought to balance the interest of shareholders with those of employees, customers and the society at large — the total real compound annual return on the stocks of the S&P 500 was 7.6 percent. From 1976 until 2012 — roughly the period of “shareholder capitalism” — the comparable return has been 6.4 percent. But the ratio of chief executive compensation to corporate profits increased eight-fold between 1980 and 2000. Almost all of that increase came from stock-based compensation.\(^5^4\)

Moreover, financialization isn’t just confined to the financial sector itself. It’s also ultimately about who controls, guides, and benefits from the US economy as a whole. The “shareholder revolution,” started in the 1980s and continuing to this very day, has fundamentally transformed the way the US economy functions in favor of wealth owners.\(^5^5\)

This change had dramatic consequences. Economist J. W. Mason found that, before the 1980s, firms tended to borrow funds in order to fuel investment. Since 1980, that link has been broken. Now when firms borrow, they tend to use the money to fund dividends or buy back stocks.\(^5^6\)

Since the 2008 banking crisis, this has been especially the case. Over the past nine years, corporate executives have taken share repurchases, corporate restructurings and “fancy footwork”—“complicated financial machinations that improve [a company’s] financial underpinnings”—to extremes. Aided by central bank-driven record low interest rates and abetted by Wall Street investment bankers, tax consultants, historically liberal accounting for acquisitions, not to mention the reappearance of corporate raiders like Icahn, maximizing shareholder value has morphed
from an accepted business norm to a CEO and corporate board obsession (Chart 15.1). Every revenue, expense and balance sheet line has been targeted for maximization. The result is that despite an anemic economic recovery, corporate profit margins are now at record highs as, too, is the stock market.\footnote{57}

The problem in the US economy is not that there isn’t enough investment capital. There’s plenty of it. As shown in Chart 15.2, the corporate profit (in US) as percent of GDP is at record high since the World War II whereas the wages as percent of GDP is at record low as shown in Chart 15.3.

U.S. corporate profits abound, but for most Americans, prosperity can’t be found. Open-market repurchases — stock buybacks — are central to the problem. From 2004 to 2013, 454 companies in the S&P 500 Index expended 51 percent of their profits, or $3.4 trillion, on repurchases, on top of 35 percent of profits on dividends. Of profits not distributed to shareholders, a big chunk was parked overseas, under a tax loophole that encourages U.S. companies not to invest at home.

More than three-quarters of compensation for the 500 highest-paid executives came from stock options and stock awards. The real bottom line: corporate profits are high, but corporate reinvestment is low. Yet business investment in productive capabilities is the foundation of sustainable prosperity. Innovative enterprises train and retain employees who work together to generate competitive products. Profits from product sales permit higher earnings that can be sustained over time. That’s how living standards rise, creating a broad-based middle class like the one America used to have. So who gains from open-market repurchases? Their sole purpose is to give a company’s stock price a manipulative boost, and prime beneficiaries are the corporate executives who decide to do them. In 2012, 83 percent of the $30.3 million in mean total compensation of the 500 highest-paid executives came from realized gains from exercising stock options and vesting of stock awards. For corporate executives, stock-based pay is a ticket to membership in the 0.1 percent top-income club.
Chart 15.1 US S&P Composite 1500 Firms’ Dividends and Buybacks (USD Billions)

Chart 15.2 Corporate Profit to GDP (US) (in percent)

Source: Federal Reserve Bank of St. Louis (US)
US vs Japan

As per the Plaza accord described in Chapter 11, the Japanese yen appreciated rapidly, and the dollar depreciated at a rate that led to the shifting of Japanese manufacturing plants to low-labor-cost countries such as Taiwan, Singapore, and then, later on, countries such as Indonesia and Thailand. In the late 1980s, in order to stop a further rise in the yen, the Bank of Japan decided on a low interest rate and spent yen to buy dollars in the currency markets. This resulted in increased Japanese investment in the United States, fueling the "bubble economy" and a collapse of the Japanese economy in the early 1990s. Japan’s Nikkei reached all time high 38,957.44 on December 29, 1989, but it plunged by nearly 50% to 20,000 during the year 1990, hitting 15,000 by 1992. It has remained below 20,000 since then, trading between 10,000 and 20,000.

The 1990s was called Lost Decade of Japan, a period of
economic stagnation in Japan following the Japanese asset price bubble’s collapse in late 1991 and early 1992. The term originally referred to the years from 1991 to 2000, but recently the decade from 2001 to 2010 is often included\(^59\), so that the whole period is referred to as the the Lost 20 Years. Broadly impacting the entire Japanese economy, over the period of 1995 to 2007, GDP fell from $5.33 to $4.36 trillion in nominal terms\(^60\), real wages fell around 5%\(^61\), while the country experienced a stagnant price level.\(^62\)

In 1995, the Japanese banking system held some 100 trillion yen (20% of their GDP at that time or USD 1 trillion at 1995 exchange rate) in bad loans. Of the top twenty-one Japanese banks, thirteen were effectively bankrupt.\(^63\)

Due to this reason, the Japanese firms even now are reluctant to hand out its profits to the shareholders to the extent which the US firms are handing to their shareholders. As shown in Charts 15.4, 15.5, 15.6 and 15.7, unlike the US, Japanese firms’ payouts in dividends and buybacks in 2013 were nearly one-sixth of the capital expenditures (Capex); this ratio peaked at one-fourth in 2007 and declined thereafter.\(^64\)

Companies in the Topix 500, excluding financial stocks, were holding almost Yen 57tn ($556bn) in gross cash at the end of March 2014 – or about two-thirds that of the $844bn held by equivalent S&P 500 companies in the US, an economy almost three times the size. The cash pile, which was up from Yen 50tn and Yen 45tn at the same points in 2012 and 2013, according to Bloomberg data, had always been attributed to two main factors: a lack of institutional investors calling for higher cash returns, and a dearth of good investment opportunities amid a sluggish economy mired in deflation. In addition, many companies are still scarred by memories of banking crises of the 1990s, says Nicholas Smith, a strategist at CLSA in Tokyo, when they found themselves unable to tap their regular lenders for funds. In that context, cash-hoarding was “entirely logical,” he says. For now, dividends are the missing link. Payouts remain at an average 27 per cent of net income among Topix-listed
Japanese-listed companies spent 42 trillion yen on capex and R&D, or 5.3 times as much as they paid out to shareholders in 2014. This was below the 7.4 times investment/payout ratio peak reached in 2009 but still way above the level seen in other major markets. In US, the investment/payout ratio is 1:1. Apart from the payouts to the shareholders, the median CEO salary at Japanese companies with revenue of more than Yen 1 trillion is one-tenth of counterparts in the U.S., and incentive pay makes up just 14 percent of the total, against 69 percent in America. Most CEOs in the Nikkei 225 stock average get less than Yen 100 million a year.

Chart 15.5 Capital Expenditure vs Dividend + Buyback in Japan (Non-Financial Corporate Firms - in Yen trillion)

Chart 15.6 **Dividends & Buybacks as Percent of Net Sales**

Source: OECD Business and Finance Scoreboard 2016
Sweden

Sweden is famed for restraint and long social democratic traditions, its executives are generally rewarded far less than rivals in the rest of Europe and the United States and appear to perform just as well, or better, for shareholders. The purchasing power of Swedish executives ranked second lowest in the Organisation of Economic Cooperation and Development (OECD) in 2009, a study by management consulting firm Hay Group showed, while 2007 Eurostat data put average pay for Swedish managers and senior officials about 20 percent below their British counterparts. At the same time, Sweden is often among the highest ranked in global competitiveness surveys while its top stocks have offered better returns than many major markets.\(^68\)
Michael Wolf, chief executive at Swedbank, and Olof Faxander, head of industrial group Sandvik, are good examples of Sweden’s relative restraint. Wolf earned 8.2 million Swedish crowns ($1.1 million) in 2011 as head of one of the Nordic region’s biggest banks. Along with other top executives, he is not eligible for a bonus. “And I’m not underpaid - relative to many workers in Sweden, I am very well paid,” he said.

By contrast, Bob Diamond at Barclays, one of the focal points during the investor revolt in 2012, took home 17 million pounds ($26 million) in 2011. Barclays’ market capitalization is about twice of Swedbank’s, yet Diamond’s pay was a full 23 times larger than Wolf’s. Likewise Faxander, whose group has about 50,000 employees worldwide, received a salary package totaling just over 10 million crowns ($1.4 million) in 2011. Pit that against Carlos Cardoso at Kennametal, a U.S. rival with 12,000 employees and a sixth of the market capitalisation of Sandvik, who made $7.6 million in 2011.

Faxander said Swedish wages for managers were set under a good system and signaled executives might be prepared to take lower pay than they could obtain abroad in exchange for other benefits, like a high standard of living and attractive scenery. “People are comfortable in the country where they live and that has an effect,” he added. The point is borne out by a Novus poll - the results of which were provided to Reuters - of about 1,300 managers and executives for Ledarna, the Swedish Organization for Managers. That showed only 4 percent wanted to move abroad to work, hardly indicating Swedish executive talent is flooding across the borders in search of better pay.

Salary restraint at the very top may also trickle down to affect managers at lower levels. A very broad measure of managers included in a recurring Ledarna survey showed the average monthly salary at a modest 38,000 crowns ($5,200). “In comparison with comparable countries, we are at a lower salary level, a considerably lower level even,” Krister Andersson, statistician at Ledarna said of top executive wages. “That may also to some extent put a cap on (salaries) for managers at lower levels. I mean, it is
not often you make more money than your CEO, even if you are in upper management.” 72

Time Magazine – Coming Nationalization in US?

A Time magazine article published in 2016 forecasted a drastic change in the “Shareholder First” model of the US companies. As per this article, in the late 1970’s, the perception was that corporate executives had failed shareholders. Today, we are nearing the tipping point at which shareholders will be blamed for the current plight of middle-class American families and communities. If history holds, just as we saw coming out of the 1970s, there is likely to be a new business model that arises from this. While it is too soon to know specifically what that model is, it likely will seek to eliminate the current voter-shareholder principal-agent problem. In the best case scenario this could occur through higher corporate taxes and higher domestic wages. The worst case would be some form of socialization/nationalization. The severity of the social mood decline will ultimately determine how voter and shareholder interests are aligned. 73

Also, once China replaces the US dollar with its own yuan as global currency, the Wall Street would collapse completely similar to the 2008-9 crash, wiping out tens of trillions of dollars of wealth in the US. It is worth noting that Dow Jones crashed from 12,474 on January 3, 2007 to 6507 on March 9, 2009, a 54% crash. Once the US sharemarket crashes, then only the US firms and the US government would realize their folly of the “Shareholder first” policy.