Frequently Asked Questions about Stock Buybacks

Policy proposals banning or curbing the rise of stock buybacks have gained traction as a critical part of the policy toolkit to correct today's high-profit, low-wage economy. Stock buybacks[1] are a strategy that corporate executives and shareholders use to extract value from corporations, rather than investing in them to create a cycle of continuous productivity growth through which workers, consumers, and the economy at large benefit. This FAQ document addresses common questions on the rise of stock buybacks and policy solutions to curb this extractive corporate practice.

Why are stock buybacks a problem that needs to be addressed?

- Stock buybacks are a major channel through which hundreds of billions of dollars exit our nation's public companies and are moved out of productive circulation. Although corporate executives do not necessarily anticipate that buybacks will increase productivity or lead to economic growth, they still prioritize this spending at the expense of other expenditures and investments.
- The scope and frequency of stock buybacks—also known as open-market share repurchases—have risen steadily over the last 30 years, a trend accelerated by the passage of the Tax Cuts and Jobs Act (TCJA) in 2017 (Palladino 2018). J.P. Morgan estimates that buyback spending increased from $530 billion in 2017 to more than $800 billion by the end of 2018 (Linnane 2018).[2]
- This substantial sum of money is flowing to a small minority of wealthy shareholders instead of being spent on workers, productive investments such as research and development (R&D), and other corporate spending that generates value in our economy. Banning or curbing stock buybacks would be an important step in restructuring corporate behavior in service of broad-based economic growth.

Do companies buy back their own stocks only when they have expended all other productive investment options?

- No. Despite proponents' claims that stock buybacks are prioritized only after other spending opportunities have been exhausted, evidence shows that buyback spending undermines other critical areas of corporate investment. Companies that underperform on earnings per share (EPS) forecasts—a quarterly Wall Street projection of expected stock value—commonly use buybacks to boost share price. The companies that engage in buybacks after missing their EPS forecasts tend to significantly reduce employment, capital expenditures, and R&D in the year following the EPS-induced buybacks (Almeida et al. 2015). This research supports the commonsense argument that companies engage in

[1] *Stock buybacks* are a practice in which corporations repurchase their own stocks from the open market to drive up share prices, without creating any underlying value.

[2] It's worth noting that it was reported that $1.1 trillion in buybacks had been authorized in 2018 (Pisani 2018).

buybacks at the expense of investing in workers, innovation, and the future of the firm.

- When defenders of buybacks refer to the unavailability of so-called “productive investments,” they are typically ignoring the possibility of investing in higher wages and improved benefits for workers, and they are also failing to acknowledge that investing in a company’s workforce improves a company’s long-term growth and potential for innovation (Ton 2014). Research shows that firms that invest in their workers actually improve productivity, profitability, and stock market performance (Hansson et. al 2002; Bassi et al. 2004).
- Finally, a growing number of companies are borrowing in order to buy back their own stocks, suggesting that the decision to repurchase shares is independent of, and does not occur only after, consideration of all other investment opportunities (Lahart 2016; Mason 2015). Goldman Sachs, for example, cites stock buybacks as an important driver of the large increases in corporate borrowing since the last recession (Alloway 2015; Bird 2015).

Aren’t buybacks a way for investors to more effectively allocate unused capital?

- No. A common but flawed argument in support of buybacks is that they serve a useful economic purpose by efficiently allocating capital between firms and throughout the economy. Here is how it works in theory: A company with unused capital buys back its stock, enriching its shareholders. These shareholders use their gains to invest in other companies—perhaps an enterprise issuing new stock because it has investment opportunities but no available capital, or a start-up. Stock buybacks supposedly allow unused capital to flow through the shareholders to companies with a greater need.
- In reality, however, the allocation of capital flowing to shareholders does not resemble this theoretical process. Buybacks instead serve as a means of enriching wealthy shareholders by diverting money away from workers and investment. First, as described above, stock buybacks are not being undertaken by companies that can’t otherwise put their funds to productive uses. Companies are issuing buybacks instead of more beneficial spending and are even taking on debt to issue buybacks. “Unused capital” is a false premise, not an accurate description of money spent on buybacks.
- Second, shareholders are not investing their buyback gains back into other public companies. The scale of shareholder payments via buybacks in recent years dwarfs new stock issuances by publicly traded nonfinancial companies (Palladino 2018). This tells us that the money being made by shareholders as a result of buybacks is being pulled out of the stock market, not being reinvested into or redistributing wealth between other publicly traded companies.
- Finally, there is no evidence that shareholders are using gains from stock buybacks to fund start-ups or other new businesses that might benefit from a reallocation of capital. The share of investment in new and small companies is actually declining, as is the rate at which new businesses form and grow (Casselman 2018; Konczal and Steinbaum 2016). Though buybacks are being issued at an unprecedented scale, capital is simply not being reallocated to other firms. The real consequences are perhaps more intuitive: Wealthy shareholders are the overwhelming beneficiaries of stock buybacks.

What will happen to retirees and pension-fund holders if stock buybacks are banned? Will they lose their savings?

- Banning stock buybacks would be a step toward refocusing the stock market on long-term growth instead of quarterly profits. Retirees would not lose their savings; rather, they would likely benefit from a ban on buybacks. Because stock buybacks generate short-term share inflation rather than long-term growth, the primary beneficiaries of buyback activities include executives with access to insider knowledge about company performance and short-term, speculative investors, such as hedge funds or private investment funds, that have little stake in a stock's long-term performance. Rather than benefitting from the short-lived boosts in share prices caused by stock buybacks, long-term investors (e.g., pension and retirement funds) are often the institutional actors forced to suffer the consequences of shortsighted decision-making. One analysis shows, for example, that companies that dedicate a greater proportion of profits to share repurchases experience lower total shareholder returns on average (Milano and Theriault 2017).
- Retirees who depend on stock market returns for their income may find that payouts in the form of dividends are preferable to gains in the form of stock buybacks. This is because a dividend payment puts cash directly into investors' hands. The only way for shareholders to make money from buybacks is by selling their shares, and the timing of such sales will affect the amount earned. Put differently, the gains from a dividend are certain; if a company provides a $10 dividend, shareholders will get exactly that amount. But if a company spends $10 buying back its own stock, and the company's stock prices rise initially and eventually fall by 50 percent, the effective distribution—the actual amount shareholders would then receive if they sold their stock—is reduced to just $5. For those retirees who depend on the value of stocks for their income, the certainty of dividends is a very good thing.
- Moreover, because fewer Americans are invested in the stock market than we have been led to believe, it is important to clarify for whom this question matters and for whom it does not. In fact, only half of Americans own any stocks at all. Even for those who do, the vast majority of wealth held in the stock market is concentrated among the very wealthy: The top 4 percent of households hold half of all stocks, while the bottom half hold just 9 percent (Wolff 2017). This means that any changes in the stock market that may result from banning stock buybacks will have a far greater impact on the very wealthy than on regular Americans.

If stock buybacks are banned, won't companies just redirect their spending to dividends? And won't that distort the economy?

- Corporations wouldn't necessarily redirect all spending to dividends if stock buybacks were banned. They could increase dividends, or they could choose to retain and reinvest the profits internally, leading to innovation and growth.
- Even if corporations did respond to a buybacks ban by increasing dividends, dividends don't have the same distortionary effect on our understanding of a company's real value. There are a number of reasons why dividends are preferable to stock buybacks:

Dividends are not oriented toward short-term gains.

Whereas buyback activity has been historically volatile, rising and falling quickly, dividends more closely track the stock market and business cycle (Leary and Michaely 2011). Because investors expect payments from dividends to be permanent, executives typically issue dividends in relation to the future profitability and growth of the company (Maubossin 2012). In other words, dividends aren't used to create an artificial "sugar high" in stock value, the way buybacks can be.

Dividends cannot be as easily exploited or manipulated by corporate executives for personal gain.

Corporate executives frequently hold large amounts of stock, and their compensation is often tied to an increase in the company's EPS metric. This means that the decision of whether and when to execute a buyback can affect executives' compensation by tens of millions of dollars. A recent analysis by SEC Commissioner Robert Jackson found that corporate executives use buybacks to exploit their insider status and grossly inflate returns on their own stock holdings. When CEOs announce that their companies will repurchase shares, it usually causes stock prices to spike. Commissioner Jackson found that executives often take advantage of the price spike they themselves engineered to cash out their shares. In fact, over a 15-month period, the number of firms with executives selling stock more than doubled immediately after buyback announcements, and the amount of stock that those executives sold increased fivefold compared to an average day (Jackson 2018).

This trend is remarkable because, in theory, companies authorize buyback programs when they believe that their shares are undervalued. But rather than hold onto their company's shares because buybacks will cause share prices to rise over time, executives take advantage of the quick bump in share price and sell for their own gain. Consequently, executives netted personal profits of $75.1 million in 2017 and the first three months of 2018. This form of manipulation and exploitation is not available with dividends.

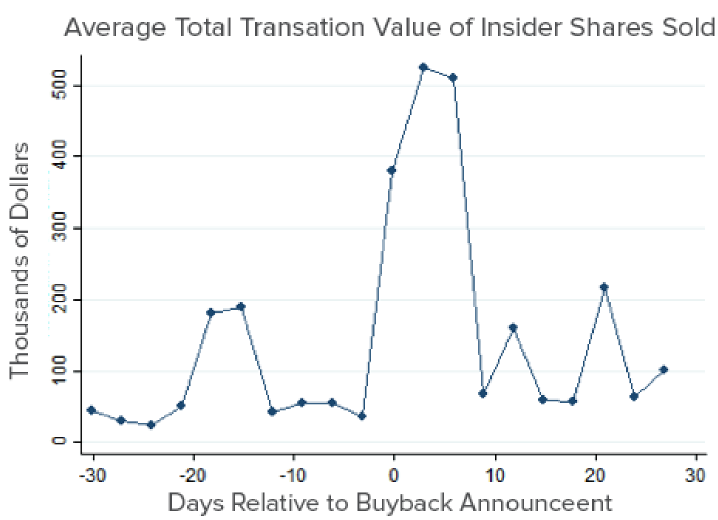

FIGURE 1 *Source: "Stock Buybacks and Corporate Cashouts," speech by SEC Commission Robert Jackson Jr.*

Dividends are taxed more fairly than buybacks.

Both buybacks and dividends are taxed at the same capital gains rate. Unlike dividends, however, buybacks require payment of capital gains taxes only when shareholder sell their shares. Shareholders can indefinitely delay taxation on the increased share price that results from buybacks. This, in turn, renders tax revenue from buybacks unpredictable. Especially at the state level, uncertainty in tax revenue can compromise public services spending and contribute to overall fiscal instability (Rueben and Randall 2017). Stocks transferred to heirs after death can avoid the capital gains tax entirely because of the step-up in basis loophole, which allows the wealthiest families to avoid billions of dollars in taxation over generations.

What are existing policy proposals to ban or curb stock buybacks?

- There are several policy proposals that have been introduced in Congress that would ban or curb the practice of stock buybacks, and more are expected.
    - The Reward Work Act would, among other things, ban the practice of open-market share repurchases, or stock buybacks. It was authored by Senator Tammy Baldwin (D-WI).
    - The Worker Dividend Act, authored by Senator Cory Booker (D-NJ), would require companies to spend the same amount on compensation for workers as they do on stock buybacks. For publicly traded companies reporting earnings of more than $250 million, every dollar spent on stock buybacks would have to be matched by allocation to a "workers dividend," split equally among all employees in a company. In addition to raising compensation for workers, this mandate would likely curb spending on stock buybacks.
    - The Stop Welfare for Any Large Monopoly Amassing Revenue from Taxpayers Act, or the Stop WALMART Act, authored by Senator Bernie Sanders (I-VT) and Representative Ro Khanna (D-CA), would prevent companies from buying back their stocks unless they pay all their employees at least $15 an hour, provide at least seven days of annual sick leave, and limit executive compensation to no more than 150 times the pay of the median worker salary. A similar proposal is expected to be introduced by Senator Chuck Schumer (D-NY) and Senator Bernie Sanders this Congress.

By helping to reorient the economy toward productive growth, restricting stock buybacks would best serve workers, pension fund holders, and the broader public good. Corporations that engage heavily in stock buybacks are working against themselves, crippling their own sustainable growth in favor of boosting stock prices. These companies are sacrificing R&D investment, capital investment, and worker wages, even as they increase their borrowing to finance more buybacks. Banning or curbing stock buybacks is one important way policymakers could help address the growing corporate debt problem.

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