WHO ARE THE SHAREHOLDERS?

> "The shareholder is a fiction. Corporations aren't a myth. Shareholders are."
>
> **The late Lynn Stout**, author of *The Shareholder Value Myth*

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ROOSEVELT INSTITUTE
REIMAGINE THE RULES

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Executive Summary

Since the end of the managerial capitalism era in about 1980—when corporate executives managed companies for the long term, workers had more bargaining power and greater economic security, and the economy was truly dynamic—corporations have singularly devoted themselves to shareholders at the expense of all other corporate stakeholders, particularly workers and consumers. Yet, for all of their influence in the current era of shareholder primacy, most of us do not actually understand who shareholders are, the role they play in our economy and society today, and the power they've amassed over the past few decades.

This report demystifies shareholders by breaking them up into three dimensions: **their identity**—who shareholders are in terms of demographics (predominantly wealthy and white households); **their role**, which challenges two mainstream conceptions about the functions that shareholders serve—that shareholders are direct owners of corporations and that they serve an ongoing funding role long after a company has gone public; and **their power**, which is concentrated in the hands of institutional investors, including activist hedge funds, and has directly shaped outcomes that prioritize shareholders first at the expense of everyone else, including depleted corporate investment, stagnate worker wages, concentrated corporate power, and rising economic inequality.

The discussion about the identity and role of shareholders should be ample motivation for policymakers who care about the groups left behind in today's high-profit, low-wage economy—including people of color, low-wage workers, and many in the middle class—to change the system. Not only is the theoretical justification for shareholder-first ideology anemic at best, but also the "benefits," or payouts, are going to mostly white, wealthy households. We cannot create good jobs, raise median wages, and, more broadly, address economic inequality, especially racial inequality, without replacing shareholder primacy with a better system of rules that shape corporate behavior. Furthermore, our analysis of shareholder power shows that dismantling shareholder primacy will require structural reforms that directly target the outsized power of institutional shareholders and the incentives that drive their decision-making.

Introduction

The ideology of "shareholder primacy" has molded 21st century American capitalism. The belief that businesses should function solely to profit this sole group of corporate stakeholders—to "maximize shareholder value"—has had a profound and toxic effect on our economy. Despite rising corporate profits, a broad shift in the balance of power towards shareholders and their obsession with next-quarter's share price (coined "short-termism") has led to the widespread extraction of productive value from businesses, with vast economic consequences—including disinvestment in productive economic growth, the dismantling of workers' economic security, and the weakening of America's long-term competitive edge in the global economy.

Thankfully shareholder primacy (or shareholder-first capitalism, as we also call it) and its consequences are garnering increasing attention. Larry Fink, the CEO of the colossal global investment firm BlackRock, made waves by calling on companies to stop focusing on quarterly stock returns (2018). Wisconsin Senator Tammy Baldwin (D-WI) recently introduced the Reward Work Act: legislation to regulate stock buybacks, a legal practice that allows companies to manipulate their own stock price to raise its value. Even *Forbes*, a mainstream business magazine, is continually calling out shareholder-first corporate behavior for driving inequality, leeching productive value out of companies, and even threatening our constitution (Georgescu 2018).

Now that shareholder primacy is coming to the forefront of our economic debates, we need to think carefully about how to dismantle it—however, we cannot address this problem without first identifying who shareholders are, how they behave, and what this means for broader economic outcomes. Lynn Stout, the late, great legal scholar who led the charge against shareholder primacy, argued that in order to weaken the hold shareholder primacy has over our economy, it's crucial that, first, we better understand shareholders. "Why is [the theory of] shareholder [primacy] value going wrong? [...] We don't understand what shareholders are" (Stout 2012). We take this statement to mean that many Americans—including policymakers, advocates, and voters—are unclear about who shareholders are, what their purpose is, and the kind of power they have over corporate decisions and our economy and society at large.

This inadequate understanding exists on both the right and the left. Referring to 2017 gains in the stock market, President Donald Trump asked a rally crowd, "How's your 401(k) doing?" despite the fact that just under half of the country, and many of his supporters, don't own any stock at all. Indeed, many policymakers talk about the stock market as if there are no barriers to entry and all Americans benefit equally. Meanwhile, some on the left have a tendency to paint all shareholders as the wealthy elite. Certainly wealthy, white Americans own the most stock, yet many shareholders, particularly through pension funds, are middle class workers and inherently prefer that American corporations prioritize long-term strategies rather than disinvest simply for the sake of next-quarter returns. This is precisely why, since the early 1990s, unions have wielded their investor power—via public pension funds—as a core strategy for holding corporations accountable.

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With Stout's argument in mind, the purpose of this report is to lift the veil from shareholders by explaining 1) their identity, 2) their role, and 3) their power. By explaining the demographic **identity** of shareholders, we challenge the notion that many Americans have a stake in the stock market. Instead, most people, particularly people of color, have not only been excluded from the benefits of today's shareholder-first economy, they have, in fact, been harmed by it. By examining the **role** of shareholders, we contest two common assumptions: first, that they are owners of corporations; and, second, that they provide the lions' share of financing for public corporations. By challenging these two premises, which have long buttressed shareholder primacy, we argue that the theoretical justification for the current rules that define corporate behavior is abating. Finally, we describe the **power** that shareholders have to influence the decisions of corporate executives and boards, how this power is unequally distributed, and how this imbalance drives extractive, short-term oriented trends in our economy.

The discussion about the identity and role of shareholders should be plenty to motivate policymakers who care about the groups left behind by today's high-profit, low-wage economy to change the system. Not only is the theoretical justification for shareholder-first ideology anemic at best, but also the "benefits" are going to mostly white, wealthy households at the expense of middle-class and low-wage workers, including people of color. We cannot create good jobs, raise median wages, and, more broadly, address racial economic inequality without replacing shareholder primacy with a better system of rules that shape corporate behavior.

If a better understanding of the role and identity of shareholders provides motivation for **why** we should dismantle shareholder primacy, our discussion of shareholder power tells us **how** we should do it. The power some shareholders wield to influence corporate strategy is mostly in the hands of institutional shareholders—particularly "activist" hedge funds that aggressively pressure corporations to extract value for their own profit. Even institutional investors that aren't as aggressive—many pension funds, mutual funds, and endowments, for example—are reinforcing the same behavior (with their approval votes) because of their own incentives for high returns. The power structure across the investor class suggests that curbing shareholder primacy will require structural reforms that target the power and incentives of institutional shareholders in order to rewrite the rules that shape corporate behavior.

DIMENSION ONE

The *Identity* of Shareholders

Who are shareholders? Despite the prevailing narrative, there are fewer American shareholders than believed, and they represent a narrow segment of our population. The press—and many politicians—tends to say that the market has been democratized, or that it is accessible to most, if not all, Americans. (Perhaps this is what has made shareholder primacy so politically palatable; why shouldn't American corporations serve shareholders if so much of the American public fall into that class?) **Yet, broad stock ownership across American society is a myth.** While largely due to a shift from pension funds to 401(k) accounts—approximately half of U.S. households do own some stock—the value of this ownership is often in very small amounts. **In reality, the top income tier in the U.S. holds the majority of stocks, and the resulting disparities in stock ownership are a core contributor to America's wealth inequality, including the widening racial wealth gap.** As much progress as we've made to understand the dynamics and effects of shareholder primacy, we have a lot of work to do to understand how it exacerbates economic inequality, particularly existing race and gender[1] disparities.

SHARE OWNERSHIP INEQUALITY

Disparities in stock ownership are well situated in America's broader economic inequality problem—in which 20 percent of all income currently goes to the 1 percent, a group that held 35 percent of the total value of wealth in 2015 (Wolff 2017). The racial income and wealth gaps in today's high-profit, low-wage economy are even more troubling. Black households earn just 59 cents for every dollar of white median household income (Flynn et al. 2017). In 2016, white families' wealth was seven times larger than that of black wealth and five times greater than for Latinx families (Darity et al. 2018).

These disparities are of course mirrored—and driven—by disparities in stock ownership. Less than 14 percent of American households own corporate stock directly.[2] Most of this ownership is concentrated among the wealthy, who receive a larger portion of their income from capital gains, while the working poor and middle class earn mainly wage and salary incomes. The middle class only owns 8 percent of all stock; by comparison, the top 1 percent owns almost 40 percent (Wolff 2017).

1 Despite its importance, we don't discuss the gender of shareholders because the Federal Reserve's Survey of Consumer Finance doesn't track this statistic. They collect data by household, not at the individual level.

2 Direct ownership of stock means that there is a stock certificate issued from a company with the owners name on it. Most Americans own stock indirectly, mainly through a pension account (46.6 percent of all households) due to the shift from traditional pensions to individual 401(k) accounts, mutual fund (9.8 percent), or trust funds (3.9 percent) (Wolff 2017). The advantage that direct shareholders have is that they have more opportunity to benefit from a meteoric rise of specific companies' share prices, whereas investing, for example, with an indexed mutual fund means broad market exposure. There's less risk, but also less payoff, if a particular company does well.

Less than 14 percent of American households own corporate stock directly.

The numbers are especially stark when we look across race and ethnic lines. In 2007, corporate stock, financial securities, mutual funds, and personal trusts comprised over 17 percent of the total assets held by white families. For black families, it shrinks to 3.4 percent and decreases to 2.5 percent for Latinx. While 60 percent of white households have retirement accounts and/or own some stock, only 34 percent of black households and 30 percent of Latinx households do (Wolff 2017).

The working class, particularly people of color, are not only failing to receive the payoffs from shareholder-first capitalism, they are arguably being disproportionately harmed. There is very little research connecting shareholder primacy with income and racial inequality, which needs to be the next step in research on this topic. In the meantime, we can connect a few of the dots.

First, shareholder primacy is creating a more insecure labor market for American workers in general. One result of the corporate focus on maximizing quarterly returns for shareholders, for example, is they have cut costs by outsourcing part of their workforce to third-party businesses—a practice termed the "fissuring of the workplace," which is restructuring the labor market to render lower-wage jobs, employment insecurity, less worker safety, and less comprehensive benefits (Weil 2014; Davis 2016).

Second, people of color are particularly affected by shareholder primacy because of their disproportionate employment in low-wage, insecure jobs. As laid out in the Roosevelt Institute's *The Hidden Rules of Race*, the racial rules of our economy—discriminatory laws, policies, institutions, regulations, and social norms, both implicit and explicit—have fostered the inequities people of color experience as workers, consumers, and small business owners (Flynn et al. 2017). Shareholder primacy exacerbates these disparities by channeling a larger percentage of workers overall into tenuous work situations that have long been the domain of people of color. For workers of color, this work is likely to become even more insecure.

Contrary to popular belief, the stock market has not been democratized. The bulk of American stockholders are wealthy and white, and the payouts to these shareholders are driving our wealth divide and impacting American workers, especially individuals and communities of color, in ways that we are just beginning to understand. In the growing discussion of shareholder primacy and its consequences, we must work to better expose these connections, including the hidden rules of race. With a more comprehensive awareness of one of the key drivers of today's high-profit, low-wage economy, we can build a movement that dismantles shareholder primacy and replaces it with an inclusive and fair corporate governance system.

DIMENSION TWO

The *Role* of Shareholders

What is it that shareholders do? The mainstream textbook story is that, *as owners of corporations*, shareholders both play an important role in finance and they vote on corporate decisions, particularly regarding board elections. Pieces of this story are true. For example, some shareholders and fund managers do vote in proxy elections, and, as we discuss in the Power section, a small minority exert enormous influence over corporate decisions through their voting and through their direct influence on boards. Yet, the notion that shareholders are owners of corporations (as though that, on its own, is *doing* something) is contested in legal debates. Further, the role of shareholders as essential funders of corporations is contested empirically. By challenging both of these mainstream assumptions on which shareholder primacy is buttressed, we argue in this section that the theoretical justifications for this ideology and system of governance have become extraordinarily thin and that **the outsized power that some shareholders have to influence corporate decisions, based on this problematic ideology, must be reined in to better match their minimal role in our corporations.**

DO SHAREHOLDERS OWN CORPORATIONS?

Shareholder primacy rests on the fallacy that shareholders are the owners of corporations. But as Stout and other legal scholars have argued, "Shareholders do not, and cannot, own corporations. Corporations are independent legal entities that own themselves" (2012). A company's shares are what shareholders own, which essentially function as contracts between the shareholders and the corporations, giving shareholders very limited rights.

> ***As Stout wrote, "Shareholders do not, and cannot, own corporations. Corporations are independent legal entities that own themselves."***

A common metaphor for share ownership is a bundle of sticks, in which each stick represents a particular right. This metaphor is designed to convey that ownership is not a binary concept; ownership has varying degrees of meaning, and we can possess some property rights but not others. Examples of ownership rights in the United States include the right of control or use; the right of benefit (e.g., the right to profit from the property); the right of transference (i.e., the right to give or sell); the right of destruction; and the right of exclusion (e.g., the right to reject access). To meaningfully call something ownership, someone would need enough ownership characteristics—enough of the sticks in a bundle—to be a legitimate owner.

If a shareholder owns 50.1 percent of a company's shares, they arguably have a meaningful amount of ownership rights. But for most shareholders of America's public corporations, who own minute fractions of total shares, they have no right of possession or right of use. They can't walk into a corporation and demand an office. They have no influence to sell the business. They can't give the company away, and they can't exclude someone from using business property or the products and services it sells.

Shareholders also don't face the liabilities that true ownership would entail. Unlike a car owner who is at fault for a car crash, shareholders are not responsible for damages corporations incur on consumers, workers, or society in general. Removing liability is an underlying purpose of the current corporate legal structure. For some critics, however, that means that, by definition, large public corporations, as a whole, cannot be owned—even by shareholders who own 50.1 percent of a company's shares.

As economic scholar John Kay explains:

> "So who does own a company? The answer is that no one does anymore than anyone owns the river Thames, the National Gallery, the streets of London, or the air we breathe. There are many different kinds of claims, contracts, and obligations in modern economics, and only occasionally are these well described by the term ownership."

Furthermore, while shareholders do rightly own their own shares, there are other corporate stakeholders who own their own inputs or means of production. As Boston College Professor of Law Kent Greenfield argues, "bondholders own their bonds, suppliers own their inventory, and employees 'own' their labor." Each of these owners contributes their property to the corporation with the expectation of making a return.

The notion of corporate ownership is what so much of shareholder primacy rests on; it is the reason why executives act to maximize shareholder value. Milton Friedman, the late Chicago School economist who is often credited with seeding shareholder-first capitalism in 1970, wrote that "a corporate executive is an employee of the owners of the business [i.e., the shareholders]. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible," without breaking the law or cheating people (Friedman 1970).

What happens to shareholder primacy when this conception of ownership—on which it rests—is debunked? Some legal scholars would argue that it doesn't matter if the logic is disproved, it's too late; shareholder primacy is now legal. Yet, the question of whether or not Delaware corporate law (where most public corporations in the U.S. are incorporated) actually dictates that corporations have a legal obligation to maximize shareholder value is a contested issue, and it would be incredibly worthwhile to bring this academic debate up for air.[3]

THE MYTH OF STOCK MARKET FINANCING

Shareholder-first capitalism is also based on the notion that a fundamental purpose of shareholders is to provide funds to corporations, a function so essential they merit priority over all other stakeholders. But as Fox and Lorsch (2012) argue in their article "What Good are Shareholders?," it is not that simple. Businesses need funds to invest in growth, but they typically don't rely on public shareholders for this financing. Net issuance of corporate equity, or the sale of new stock, for non-financial companies is historically low. In fact, between 2007 and 2016, it has been negative at an average of minus $412 billion per year (Lazonick 2017).

Once a private company has its initial public offering, or IPO, (i.e., gone public), it is less shareholders than the stock market in general that indirectly serves a funding role. In other words, the markets are providing the space for shares to be easily bought and sold (i.e., liquidity) on the secondary market, which reassures corporate lenders, the people actually doing the financing. According to Fox and Lorsch, "established corporations tend to finance investments out of retained earnings or borrowed money. They don't need shareholders' cash." Economist William Lazonick agrees with this argument: "Academic research on sources of corporate finance shows that, compared with other sources of funds, stock markets in advanced countries have been insignificant suppliers of capital for corporations" (2017).

In fact, funding is arguably flowing in the reverse direction, as corporations, through the practice of stock buybacks, have become huge fund suppliers to the stock market. (See the "Stock Buybacks: Driving Today's High-Profit, Low-Wage Economy" section below.) These wasteful payouts to shareholders are occurring even to the point of borrowing money to do so, according to Roosevelt Institute Fellow J.W. Mason: "Today, there is a strong correlation between shareholder payouts and borrowing, a relationship that did not exist before the mid-1980s" (Mason 2014). The conventional wisdom about shareholders is that they are essential for funding corporations. Indeed, they are crucial for starting businesses, but they are increasingly less important for continued productivity and growth.

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[3] See *The New York Times*' "Room for Debate" series: "Etsy's I.P.O. and Public Corporations' Obligations to Shareholders."

The weaknesses of the two core arguments for shareholder primacy—that shareholders are owners of corporations and that they are necessary for ongoing corporate financing (unlike the stock market in general)—suggest that the current way we run our corporations in the U.S., and the outsized power some shareholders have to sway corporate strategy decisions, lacks crucial justification. **In truth, shareholders of public corporations serve very little purpose after the IPO, and their power should reflect this minimal role.** The next section on the power dynamics of shareholders provides a path forward to accomplish this.

STOCK BUYBACKS: DRIVING TODAY'S HIGH-PROFIT, LOW-WAGE ECONOMY

Stock buybacks, or share repurchases, are a practice in which companies buy back their own stock from shareholders, typically on the open market (the alternative is through a private exchange called "tender offers"), to inflate share prices. When a share of stock is bought back, the company reabsorbs the portion of its ownership that was previously distributed among other investors. According to economist William Lazonick, the purported theory behind performing buybacks is that they can offset employee stock options, boost undervalued stock prices, or transition a public company to go private again (Lazonick 2014). But evidence shows that open-market share repurchases specifically are often used to manipulate stock prices at the behest of shareholders who want to play the market, including executives who know exactly when to exercise their stock options or sell their stock based on when their companies are performing buybacks.

What is especially troubling about the practice of buybacks—a growing trend across S&P 500 companies (Imbert 2018)—is that, by choosing to buy back publicly held shares, companies are able to push up their stock price without actually investing in the company's capital, research and development, or its workers. In other words, while corporate profits are high, companies are reallocating their resources away from economic productivity in order to payoff shareholders. According to Konczal et al., "Before the 1970s, American corporations consistently paid out around 50 percent of their profits to shareholders, retaining the rest for investment. But over the past 30 years, shareholder payouts have averaged 90 percent of reported profits" (2015). Most of those payouts come in the form of buybacks.

For more information on stock buybacks and how to curb this extractive corporate behavior, see the recent issue brief from economist Lenore Palladino (2018).

DIMENSION THREE

The *Power* of Shareholders

Who owns or controls shares is not only important for how wealth is distributed; **this also shapes the distribution of power among shareholders, which matters enormously for economic outcomes.** While shareholders of early joint-stock companies, like Carnegie Steel, exerted direct power over these companies, today's disparate share ownership means most individual, private shareholders don't have any meaningful governance power. In their wake, institutional shareholders are the central conduits of share ownership and governance power, which, because of their own market incentives, is driving today's shareholder primacy and short-termism trends.

Institutional investors are organizations that invest on behalf of clients. They come in a range of forms, from public and private pension funds to university endowments, mutual funds, and hedge funds. While approximately half (51 percent) of the over 126 million households in America own corporate stocks, most (47 percent) hold them indirectly through institutional investors, particularly through their individual pension accounts (Wolff 2017). Collectively, institutional investors—BlackRock, Vanguard, and State Street, the largest—control 80 percent of the S&P 500 index; the dollar value of their control is approximately $18 trillion (McGrath 2017).

"ACTIVIST" HEDGE FUNDS

To be sure, the most powerful shareholders are "activist" hedge funds, which are akin to the corporate raiders of the 1980s and are increasingly pressuring corporations to abandon any existing long-term strategy for a quick boost in share price.[4] With just a small percentage of a company's shares (6 percent, on average) and relatively brief share ownership (averaging two years), they push companies to cut costs by laying off workers and selling assets, and they implore them to use company coffers by buying back stocks to elevate price—which amounts to insider trading (Park 2016; Brav et al. 2012).

Additionally, many hedge funds pressure companies to sell themselves to their competitors in order to bump up share prices before they themselves cash out. One report estimates that hedge funds are driving 25 percent of today's mergers trend, which is fostering the increasing concentration of corporate power—the likes of which we have not seen since the Gilded Age (Toppan Vite 2015).

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[4] The term "activist" refers to investors—hedge fund or otherwise—who obtain enough corporate shares in order to garner influence and effect change at a company.

PASSIVE-AGGRESSIVE INSTITUTIONAL INVESTORS

While activist hedge funds are explicitly aggressive in their strategies to extract value out of companies, many other institutional investors, including mutual funds, endowments, and some pension funds,[5] are better characterized as passive-aggressive. Because they manage such large swaths of the whole stock market, these investors aren't exerting the same kind of pressure on any one public corporation, but they are also not pushing back against extractive corporate practices because they ultimately benefit from the same outcomes. While many of the individual investors that these organizations represent are in it for the long haul, institutional investors are incentivized to attract clients by showing them higher and higher returns. The combination of that short-term motivation of institutional investors with the enormous power they hold (because they control so much stock) over a company's business decisions means that these investors tend to support the usual suite of self-serving, extractive strategies, including cutting research and development (R&D) and labor costs, buying back stocks, and selling off assets or even the company.

> ***The combination of the short-term motivation of institutional investors with the enormous power they hold over a company's business decisions means that these investors tend to support the usual suite of self-serving, extractive strategies.***

One way the outsized power of institutional investors—and their profits—is amplified is when institutional investors themselves invest with activist hedge funds who can give them above market returns; partnerships that will only fuel activist campaigns and reinforce the problematic economic outcomes of shareholder primacy. Yale University's endowment has been under fire recently for investing—through four different hedge funds—in Puerto Rico's debt (Dayen 2018). State Street Global Advisors, a leading index investor, said that they are willing to work with activists to achieve their corporate governance goals (i.e., make money), and investment manager Neuberger Berman recently announced that they bought a 20 percent stake in JANA Partners, the hedge fund that pressured Whole Foods to sell to Amazon (Holmberg 2018). According to Dan Romito, writing for *Harvard Business Review*, institutional investors increasingly think of investing with activists as "a value-based strategy that optimizes untapped shareholder wealth" (2015). Indeed, these partnerships will surely tap new opportunities for shareholder wealth—at the expense of workers, consumers, the long-term health of companies, and our economy overall.

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5 There are of course exceptions. For example, some public pension funds—like CalPERS, the pension fund for public workers in California—use their power as shareholders to fight extractive pressure on corporations (Webber 2018).

EXECUTIVE PAY PACKAGES

The passivity of institutional investors—and its own role in driving next-quarter decisions—is exemplified within executive pay issues, as well. In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act gave shareholders the right to provide a non-binding vote on executive pay packages as a way to signal shareholder opinion on growing trends in these exorbitant deals. (See the "Perfomance Pay" section below.) During 2012, only 16 percent of mutual fund families, which owned more than 20 percent of all shares in U.S. public companies, voted against "Say-on-Pay" proposals, despite the fact that the average CEO pay for that year was over 14 million (Sabadish and Mishel 2013).

> ***The passivity of institutional investors—and its own role in driving next-quarter decisions—is exemplified within executive pay issues, as well.***

While the most powerful institutional investors are generally the least likely to resist high executive pay,[6] there are key incentive issues that make the majority of these groups reluctant to disapprove of exorbitant pay packages. Mutual fund investors, which alone manage more than 20 percent of shares in U.S. public companies, are managing pension and 401(k) plans for public corporations and are directly retained by the very executives whose pay packages they are asked to approve—a clear conflict of interest (Holmberg and Umbrecht 2014; Stout 2012). Further, because of time and resource constraints, investors rely heavily on proxy advisor services, particularly Institutional Shareholder Services (ISS) and Glass Lewis, for voting advice. According to one report, a negative recommendation from ISS will influence between approximately 14 percent and 21 percent of votes on managements' proposals on average (Larcker et al. 2015). The problem is that the services themselves tend not to provide enough due diligence around shortsighted practices, including equity-heavy executive pay packages, so they often recommend approving this pay and thus reinforce the problem.

[6] An American Federation of State, County, and Municipal Employees (AFSCME) report revealed that the largest mutual fund investors—Vanguard, BlackRock, ING, and Lord Abbett—were much less likely to object to management compensation proposals. Their sheer size, and thus power, means that their voices vastly outweigh the preferences of the smaller funds, which are much more likely to vote against high pay packages (2011).

PERFORMANCE PAY

One of the first policies that helped legally codify shareholder-first capitalism was the performance pay loophole (which was closed without any fanfare in the 2018 Republican tax reform bill). In his 1992 campaign, a key issue for President Bill Clinton was the expanding paychecks of corporate executives. His idea was to cap deductions for executive pay at $1 million, which, in 1993, became part of the U.S. tax code as Section 162(m). There were, however, a few exceptions made at the last minute to this rule; most notably, one for executive pay that qualified it as "performance-based," which, coming in the form of mostly corporate equity, exhibited what agency theorists mean by aligning executive and shareholder interests.

Once Section 162(m) became law, companies, predictably, started dispensing more compensation that qualified as performance pay, particularly stock options. Median executive compensation levels for S&P 500 industrial companies almost tripled in the 1990s, partly driven by a dramatic growth in stock options, which doubled in frequency.

Performance pay can (and has) made executives very wealthy, very quickly—an exchange that not only drives economic inequality but also creates incentives for shortsighted, excessively high-risk, and occasionally fraudulent decisions in order to boost stock prices. What kind of effect does this behavior have on the economy at large? Many economists argue that executive stock options dolled out in the financial industry played a meaningful role in the mortgage crisis and subsequent global financial meltdown. Economists involved in the Squam Lake Working Group on Financial Regulation (2010) argued that the structure of executive pay can affect the risk of "systemically important" financial institutions. "Because the owners [...] of financial firms do not bear the full cost of their failures, they have an incentive to take more risk than they otherwise would. This, in turn, increases the chance of bank failures, systemic risk, and taxpayer costs." Performance pay also diminishes long-term spending because companies buy back stocks to offset (i.e., pay for) the "dilutive" effects of executive stock options on corporate stock prices.

A lot of money has moved up to executives, but everyday Americans got the bill. Beyond the innumerable costs we've borne from the recent economic crisis, Balsam (2012) calculated that taxpayers have subsidized $30 billion to corporations between 2007 and 2010 for the performance pay loophole. According to a 2013 Public Citizen report, the top 20 highest-paid CEOs received salaries totaling $28 million, but they also had deductible performance-based compensation totaling over $738 million (Crowther 2013). Assuming a 35 percent tax rate, that's a $235 million unpaid tax bill. The Institute for Policy Studies calculated that between 2011 and 2013, the CEOs of the top 6 publicly held fast food chains "pocketed more than $183 million in performance pay, lowering their companies' IRS bills by an estimated $64 million" (Anderson 2013).

It has not been well publicized that the recent Republican tax bill closed the performance pay loophole. It remains to be seen if corporations will pay less in corporate equity, particularly stock options, or if (more likely) the toothpaste is out of the tube and equity-heavy pay packages, with their associated problems, are here to stay.

TARGETING SHAREHOLDER POWER IS THE KEY TO SHAREHOLDER PRIMACY REFORM

Some might argue that, because shareholder primacy began with the bad ideas of a few economists, the way to address shareholder primacy is to simply replace those ideas by changing how people think about the corporation. While we agree that reform has to happen at a cultural level, particularly in the social norms and expectations created within business, economics, and law departments and classrooms, we must also recognize that shareholder primacy has been codified by a variety of policies that have reinforced shareholder power. As such, it is going to take policy reforms to dismantle those powers.

The extractive, value-diminishing effects of shareholder primacy stem from the outsized power and distorted incentives of institutional investors, particularly activist hedge funds. It stands to reason, then, that dismantling shareholder primacy to curb these trends will require structural reforms that target the power and/or the incentives of institutional shareholders.

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In terms of targeting shareholder power, one idea is to build countervailing worker power with a federal law that requires sizeable representation of workers on the boards of public corporations. As the German example of this law has demonstrated, putting workers at the table where issues like executive pay packages and stock buybacks are decided will help abate these trends (Holmberg 2017). In terms of regulating incentives, Palladino (2018) argues that prohibiting open-market stock buybacks is crucial. In addition, taxing capital gains at the same (or higher) rate as ordinary income would provide lower financial returns for hedge funds and would help curb skyrocketing executive pay by making stock options less tax advantageous. More direct solutions include a luxury tax on excessive CEO pay or a ban on equity pay for executives altogether. This is in no way a comprehensive list, but simply a few examples to illustrate how to weaken the hold institutional shareholders have over our public corporations and economy.

Conclusion

Lynn Stout made a crucial point about shareholder primacy: We can't dismantle it without first understanding the complex nature of shareholders and the impact they have on our economy and society. This report has tried to fill this gap by describing the three dimensions of shareholders: their identity, role, and power. We first described shareholder demographic identity, pushing back against the media allegory that the stock market has been democratized in the U.S. Mostly very wealthy, white households are benefiting from today's high-profit, low-wage economy, and workers and low- and middle-class communities, including communities of color, will continue to not only be left out but also disproportionately harmed. We then contest mainstream conceptions about what shareholders do, that corporations are primarily dependent on shareholders for financing and, as owners, corporations exist for the sole purpose of extracting corporate value to payoff shareholders. These arguments should be enough to motivate concerned policymakers to dismantle shareholder primacy. Finally, we addressed how to do this by peeling back the third layer: shareholder power. Because institutional shareholders, especially hedge funds, manage and own so much stock, their outsized power over our economy—and their respective incentives, which reinforce predatory value extraction—must be combated with policies that target both the power and incentives.

We cannot create good jobs, raise median wages, and, more broadly, address economic inequality, especially racial inequality, without replacing shareholder primacy with a better system of rules that shape corporate behavior. Only then can we build an innovative and fair economy that is truly inclusive of all stakeholders, especially workers.

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