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THE BIG IDEA

Profits Without Prosperity

**Stock buybacks manipulate the market
and leave most Americans worse off.**

by William Lazonick

The Big Idea



profits without prosperity

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STOCK BUYBACKS
MANIPULATE THE
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BY WILLIAM LAZONICK

Five years after the official end of the Great Recession, corporate profits are high, and the stock market is booming. Yet most Americans are not sharing in the recovery. While the top 0.1% of income recipients—which include most of the highest-ranking corporate executives—reap almost all the income gains, good jobs keep disappearing, and new employment opportunities tend to be insecure and underpaid.

PHOTOGRAPHY: ELISE

Corporate profitability is not translating into widespread economic prosperity.

The allocation of corporate profits to stock buybacks deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their earnings—a total of \$2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their earnings. That left very little for investments in productive capabilities or higher incomes for employees.

The buyback wave has gotten so big, in fact, that even shareholders—the presumed beneficiaries of all this corporate largesse—are getting worried. “It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies,” Laurence Fink, the chairman and CEO of BlackRock, the world’s largest asset manager, wrote in an open letter to corporate America in March. “Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks.”

Why are such massive resources being devoted to stock repurchases? Corporate executives give several

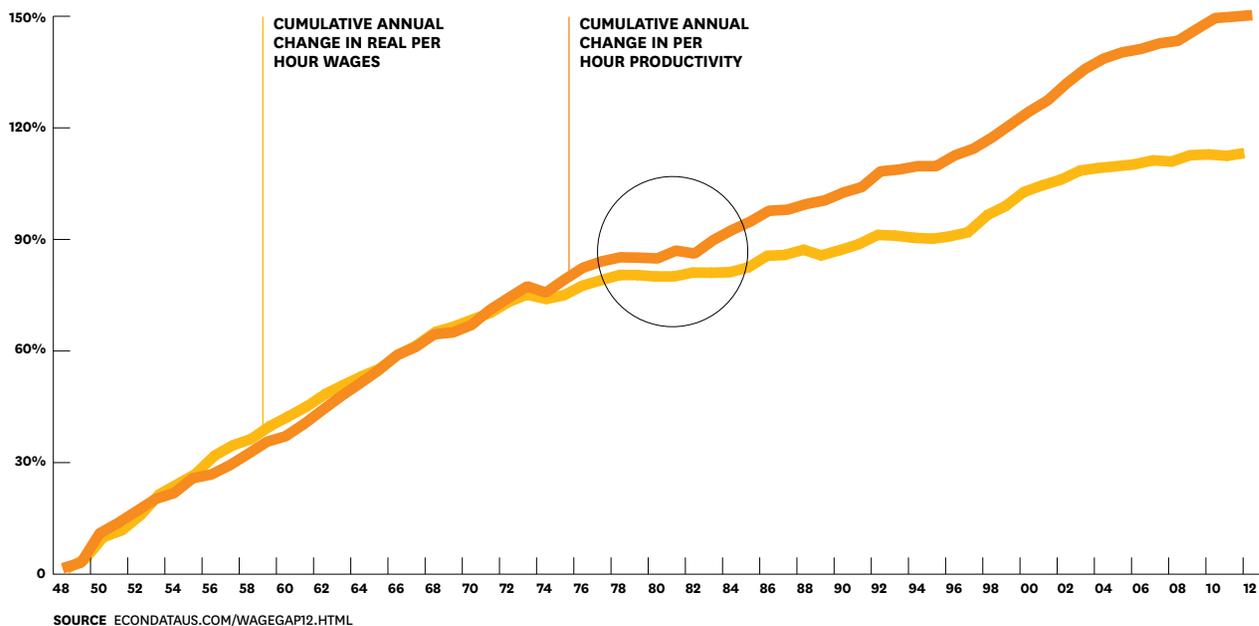
reasons, which I will discuss later. But none of them has close to the explanatory power of this simple truth: Stock-based instruments make up the majority of their pay, and in the short term buybacks drive up stock prices. In 2012 the 500 highest-paid executives named in proxy statements of U.S. public companies received, on average, \$30.3 million each; 42% of their compensation came from stock options and 41% from stock awards. By increasing the demand for a company’s shares, open-market buybacks automatically lift its stock price, even if only temporarily, and can enable the company to hit quarterly earnings per share (EPS) targets.

As a result, the very people we rely on to make investments in the productive capabilities that will increase our shared prosperity are instead devoting most of their companies’ profits to uses that will increase their own prosperity—with unsurprising results. Even when adjusted for inflation, the compensation of top U.S. executives has doubled or tripled since the first half of the 1990s, when it was already widely viewed as excessive. Meanwhile, overall U.S. economic performance has faltered.

If the U.S. is to achieve growth that distributes income equitably and provides stable employment,

WHEN PRODUCTIVITY AND WAGES PARTED WAYS

From 1948 to the mid-1970s, increases in productivity and wages went hand in hand. Then a gap opened between the two.



Idea in Brief**THE PROBLEM**

Corporate profitability is not translating into economic prosperity in the United States. Instead of investing profits in innovation and productive capabilities, U.S. executives are spending them on gigantic stock repurchases.

THE RESEARCH

These buybacks may increase stock prices in the short term, but in the long term they undermine income equality, job stability, and growth. The buybacks mostly serve the interests of executives, much of whose compensation is in the form of stock.

THE SOLUTION

Corporations should be banned from repurchasing their shares on the open market. Executives' excessive stock-based pay should be reined in. Workers and taxpayers should be represented on corporate boards. And Congress should reform the tax system so that it rewards value creation, not value extraction.

government and business leaders must take steps to bring both stock buybacks and executive pay under control. The nation's economic health depends on it.

FROM VALUE CREATION TO VALUE EXTRACTION

For three decades I've been studying how the resource allocation decisions of major U.S. corporations influence the relationship between *value creation* and *value extraction*, and how that relationship affects the U.S. economy. From the end of World War II until the late 1970s, a *retain-and-reinvest* approach to resource allocation prevailed at major U.S. corporations. They retained earnings and reinvested them in increasing their capabilities, first and foremost in the employees who helped make firms more competitive. They provided workers with higher incomes and greater job security, thus contributing to equitable, stable economic growth—what I call “sustainable prosperity.”

This pattern began to break down in the late 1970s, giving way to a *downsize-and-distribute* regime of reducing costs and then distributing the freed-up cash to financial interests, particularly shareholders. By favoring value extraction over value creation, this approach has contributed to employment instability and income inequality.

As documented by the economists Thomas Piketty and Emmanuel Saez, the richest 0.1% of U.S. households collected a record 12.3% of all U.S. income in 2007, surpassing their 11.5% share in 1928, on the eve of the Great Depression. In the financial crisis of 2008–2009, their share fell sharply, but it has since rebounded, hitting 11.3% in 2012.

Since the late 1980s, the largest component of the income of the top 0.1% has been compensation, driven by stock-based pay. Meanwhile, the growth of workers' wages has been slow and sporadic, except during the internet boom of 1998–2000, the

only time in the past 46 years when real wages rose by 2% or more for three years running. Since the late 1970s, average growth in real wages has increasingly lagged productivity growth. (See the exhibit “When Productivity and Wages Parted Ways.”)

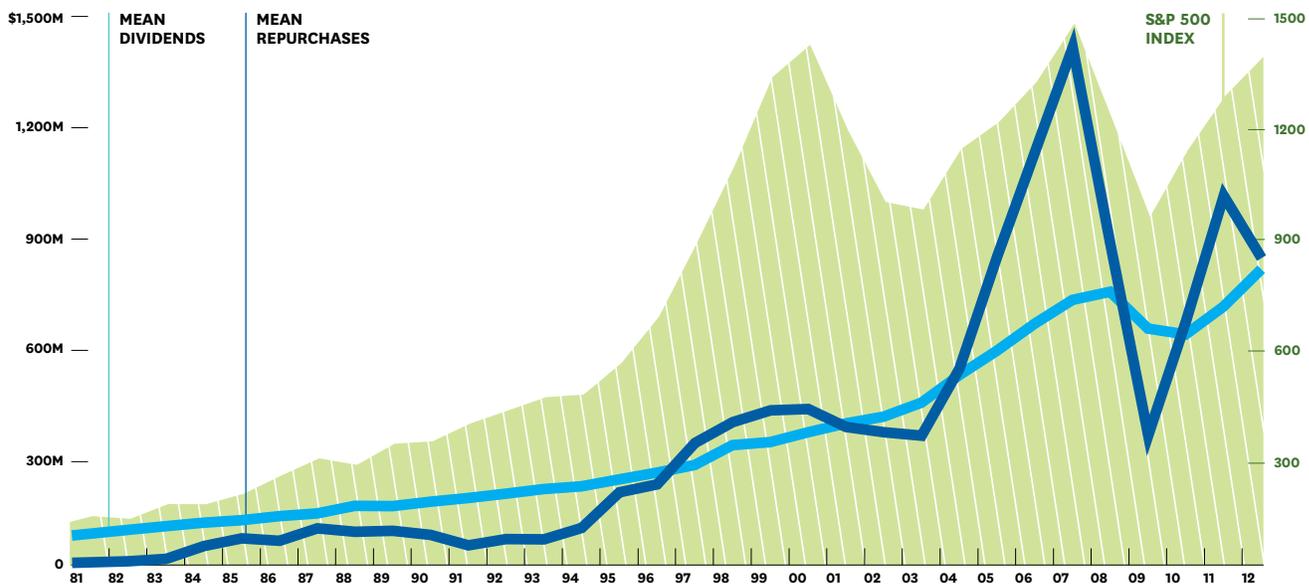
Not coincidentally, U.S. employment relations have undergone a transformation in the past three decades. Mass plant closings eliminated millions of unionized blue-collar jobs. The norm of a white-collar worker's spending his or her entire career with one company disappeared. And the seismic shift toward offshoring left all members of the U.S. labor force—even those with advanced education and substantial work experience—vulnerable to displacement.

To some extent these structural changes could be justified initially as necessary responses to changes in technology and competition. In the early 1980s permanent plant closings were triggered by the inroads superior Japanese manufacturers had made in consumer-durable and capital-goods industries. In the early 1990s one-company careers fell by the wayside in the IT sector because the open-systems architecture of the microelectronics revolution devalued the skills of older employees versed in proprietary technologies. And in the early 2000s the offshoring of more-routine tasks, such as writing unsophisticated software and manning customer call centers, sped up as a capable labor force emerged in low-wage developing economies and communications costs plunged, allowing U.S. companies to focus their domestic employees on higher-value-added work.

These practices chipped away at the loyalty and dampened the spending power of American workers, and often gave away key competitive capabilities of U.S. companies. Attracted by the quick financial gains they produced, many executives ignored the long-term effects and kept pursuing them well past the time they could be justified.

WHERE DID THE MONEY FROM PRODUCTIVITY INCREASES GO?

Buybacks—as well as dividends—have skyrocketed in the past 20 years. (Note that these data are for the 251 companies that were in the S&P 500 in January 2013 and were public after 1981 through 2012. Inclusion of firms that went public after 1981, such as Microsoft, Cisco, Amgen, Oracle, and Dell, would make the increase in buybacks even more marked.) Though executives say they repurchase only undervalued stocks, buybacks increased when the stock market boomed, casting doubt on that claim.



SOURCE STANDARD & POOR'S COMPUSTAT DATABASE; THE ACADEMIC-INDUSTRY RESEARCH NETWORK. NOTE MEAN REPURCHASE AND DIVIDEND AMOUNTS ARE IN 2012 DOLLARS.

A turning point was the wave of hostile takeovers that swept the country in the 1980s. Corporate raiders often claimed that the complacent leaders of the targeted companies were failing to maximize returns to shareholders. That criticism prompted boards of directors to try to align the interests of management and shareholders by making stock-based pay a much bigger component of executive compensation.

Given incentives to maximize shareholder value and meet Wall Street's expectations for ever higher quarterly EPS, top executives turned to massive stock repurchases, which helped them "manage" stock prices. The result: 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 shares for what is effectively stock-price manipulation.

GOOD BUYBACKS AND BAD

Not all buybacks undermine shared prosperity. There are two major types: tender offers and open-market repurchases. With the former, a company contacts shareholders and offers to buy back their

shares at a stipulated price by a certain near-term date, and then shareholders who find the price agreeable tender their shares to the company. Tender offers can be a way for executives who have substantial ownership stakes and care about a company's long-term competitiveness to take advantage of a low stock price and concentrate ownership in their own hands. This can, among other things, free them from Wall Street's pressure to maximize short-term profits and allow them to invest in the business. Henry Singleton was known for using tender offers in this way at Teledyne in the 1970s, and Warren Buffett for using them at GEICO in the 1980s. (GEICO became wholly owned by Buffett's holding company, Berkshire Hathaway, in 1996.) As Buffett has noted, this kind of tender offer should be made when the share price is below the intrinsic value of the productive capabilities of the company and the company is profitable enough to repurchase the shares without impeding its real investment plans.

But tender offers constitute only a small portion of modern buybacks. Most are now done on the open market, and my research shows that they often come at the expense of investment in productive

capabilities and, consequently, aren't great for long-term shareholders.

Companies have been allowed to repurchase their shares on the open market with virtually no regulatory limits since 1982, when the SEC instituted Rule 10b-18 of the Securities Exchange Act. Under the rule, a corporation's board of directors can authorize senior executives to repurchase up to a certain dollar amount of stock over a specified or open-ended period of time, and the company must publicly announce the buyback program. After that, management can buy a large number of the company's shares on any given business day without fear that the SEC will charge it with stock-price manipulation—provided, among other things, that the amount does not exceed a “safe harbor” of 25% of the previous four weeks' average daily trading volume. The SEC requires companies to report total quarterly repurchases but not daily ones, meaning that it cannot determine whether a company has breached the 25% limit without a special investigation.

Despite the escalation in buybacks over the past three decades, the SEC has only rarely launched proceedings against a company for using them to manipulate its stock price. And even within the 25% limit, companies can still make huge purchases: Exxon Mobil, by far the biggest stock repurchaser from 2003 to 2012, can buy back about \$300 million worth of shares a day, and Apple up to \$1.5 billion a day. In essence, Rule 10b-18 legalized stock market manipulation through open-market repurchases.

The rule was a major departure from the agency's original mandate, laid out in the Securities Exchange Act in 1934. The act was a reaction to a host of unscrupulous activities that had fueled speculation in the Roaring '20s, leading to the stock market crash of 1929 and the Great Depression. To prevent such shenanigans, the act gave the SEC broad powers to issue rules and regulations.

During the Reagan years, the SEC began to roll back those rules. The commission's chairman from 1981 to 1987 was John Shad, a former vice chairman of E.F. Hutton and the first Wall Street insider to lead the commission in 50 years. He believed that the deregulation of securities markets would channel savings into economic investments more efficiently and that the isolated cases of fraud and manipulation that might go undetected did not justify onerous disclosure requirements for companies. The SEC's adoption of Rule 10b-18 reflected that point of view.

DEBUNKING THE JUSTIFICATIONS FOR BUYBACKS

Executives give three main justifications for open-market repurchases. Let's examine them one by one:

1 Buybacks are investments in our undervalued shares that signal our confidence in the company's future. This makes some sense. But the reality is that over the past two decades major U.S. companies have tended to do buybacks in bull markets and cut back on them, often sharply, in bear markets. (See the exhibit “Where Did the Money from Productivity Increases Go?”) They buy high and, if they sell at all, sell low. Research by the Academic-Industry Research Network, a nonprofit I cofounded and lead, shows that companies that do buybacks never resell the shares at higher prices.

Once in a while a company that bought high in a boom has been forced to sell low in a bust to alleviate financial distress. GE, for example, spent \$3.2 billion on buybacks in the first three quarters of 2008, paying an average price of \$31.84 per share. Then, in the last quarter, as the financial crisis brought about losses at GE Capital, the company did a \$12 billion stock issue at an average share price of \$22.25, in a failed attempt to protect its triple-A credit rating.

In general, when a company buys back shares at what turn out to be high prices, it eventually reduces the value of the stock held by continuing shareholders. “The *continuing* shareholder is penalized by repurchases above intrinsic value,” Warren Buffett wrote in his 1999 letter to Berkshire Hathaway shareholders. “Buying dollar bills for \$1.10 is not good business for those who stick around.”

2 Buybacks are necessary to offset the dilution of earnings per share when employees exercise stock options. Calculations that I have done for high-tech companies with broad-based stock option programs reveal that the volume of open-market repurchases is generally a multiple of the volume of options that employees exercise. In any case, there's no logical economic rationale for doing repurchases to offset dilution from the exercise of employee stock options. Options are meant to motivate employees to work harder now to produce higher future returns for the company. Therefore, rather than using corporate cash to boost EPS immediately, executives should be willing to wait for the incentive to work. If the company generates higher earnings, employees can exercise their options at higher stock prices, and the company can allocate the increased earnings to investment in the next round of innovation.

3 Our company is mature and has run out of profitable investment opportunities; therefore, we should return its unneeded cash to shareholders. Some people used to argue that buybacks were a more tax-efficient means of distributing money to shareholders than dividends. But that has not been the case since 2003, when the tax rates on long-term capital gains and qualified dividends were made the same. Much more important issues remain, however: What is the CEO’s main role and his or her responsibility to shareholders?

Companies that have built up productive capabilities over long periods typically have huge organizational and financial advantages when they enter related markets. One of the chief functions of top executives is to discover new opportunities for those capabilities. When they opt to do large open-market repurchases instead, it raises the question of whether these executives are doing their jobs.

A related issue is the notion that the CEO’s main obligation is to shareholders. It’s based on a misconception of the shareholders’ role in the modern corporation. The philosophical justification for giving them all excess corporate profits is that they are best positioned to allocate resources because they have the most interest in ensuring that capital generates

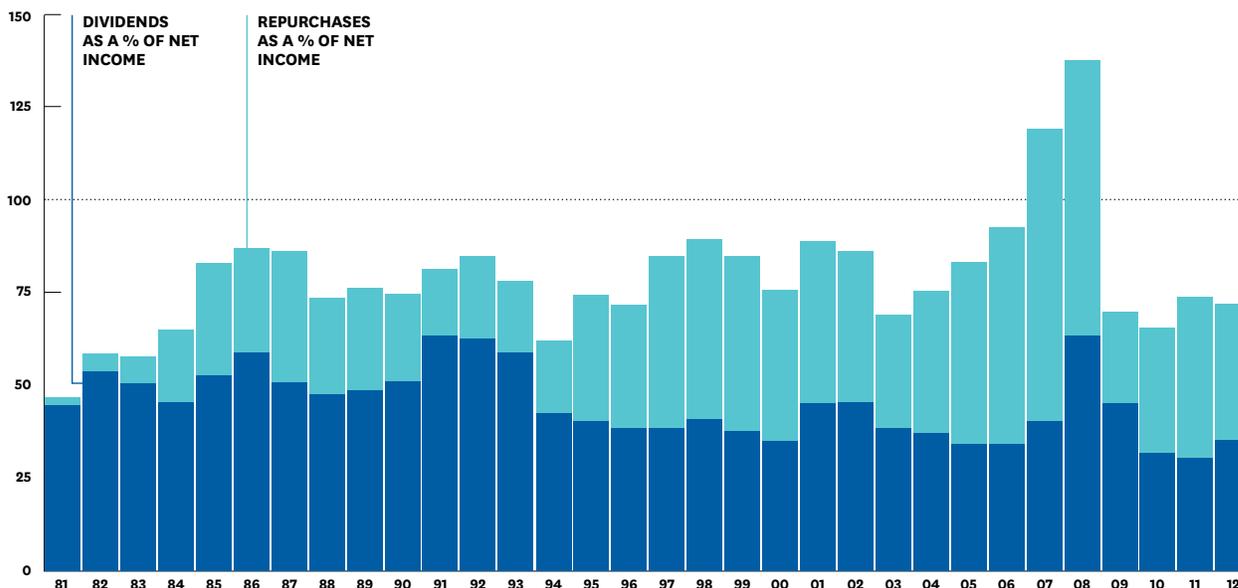
the highest returns. This proposition is central to the “maximizing shareholder value” (MSV) arguments espoused over the years, most notably by Michael C. Jensen. The MSV school also posits that companies’ so-called free cash flow should be distributed to shareholders because only they make investments without a guaranteed return—and hence bear risk.

But the MSV school ignores other participants in the economy who bear risk by investing without a guaranteed return. *Taxpayers* take on such risk through government agencies that invest in infrastructure and knowledge creation. And *workers* take it on by investing in the development of their capabilities at the firms that employ them. As risk bearers, taxpayers, whose dollars support business enterprises, and workers, whose efforts generate productivity improvements, have claims on profits that are at least as strong as the shareholders’.

The irony of MSV is that public-company shareholders typically never invest in the value-creating capabilities of the company at all. Rather, they invest in outstanding shares in the hope that the stock price will rise. And a prime way in which corporate executives fuel that hope is by doing buybacks to manipulate the market. The only money that Apple ever raised from public shareholders was \$97 million at its IPO in 1980.

WHY MONEY FOR REINVESTMENT HAS DRIED UP

Since the early 1980s, when restrictions on open-market buybacks were greatly eased, distributions to shareholders have absorbed a huge portion of net income, leaving much less for reinvestment in companies.



NOTE: DATA ARE FOR THE 251 COMPANIES THAT WERE IN THE S&P 500 INDEX IN JANUARY 2013 AND WERE PUBLICLY LISTED FROM 1981 THROUGH 2012. IF THE COMPANIES THAT WENT PUBLIC AFTER 1981, SUCH AS MICROSOFT, CISCO, AMGEN, ORACLE, AND DELL, WERE INCLUDED, REPURCHASES AS A PERCENTAGE OF NET INCOME WOULD BE EVEN HIGHER.

Yet in recent years, hedge fund activists such as David Einhorn and Carl Icahn—who played absolutely no role in the company’s success over the decades—have purchased large amounts of Apple stock and then pressured the company to announce some of the largest buyback programs in history.

The past decade’s huge increase in repurchases, in addition to high levels of dividends, have come at a time when U.S. industrial companies face new competitive challenges. This raises questions about how much of corporate cash flow is really “free” to be distributed to shareholders. Many academics—for example, Gary P. Pisano and Willy C. Shih of Harvard Business School, in their 2009 HBR article “Restoring American Competitiveness” and their book *Producing Prosperity*—have warned that if U.S. companies don’t start investing much more in research and manufacturing capabilities, they cannot expect to remain competitive in a range of advanced technology industries.

Retained earnings have always been the foundation for investments in innovation. Executives who subscribe to MSV are thus copping out of their responsibility to invest broadly and deeply in the productive capabilities their organizations need to continually innovate. MSV as commonly understood is a theory of value extraction, not value creation.

EXECUTIVES ARE SERVING THEIR OWN INTERESTS

As I noted earlier, there is a simple, much more plausible explanation for the increase in open-market repurchases: the rise of stock-based pay. Combined with pressure from Wall Street, stock-based incentives make senior executives extremely motivated to do buybacks on a colossal and systemic scale.

Consider the 10 largest repurchasers, which spent a combined \$859 billion on buybacks, an amount equal to 68% of their combined net income, from 2003 through 2012. (See the exhibit “The Top 10 Stock Repurchasers.”) During the same decade, their CEOs received, on average, a total of \$168 million each in compensation. On average, 34% of their compensation was in the form of stock options and 24% in stock awards. At these companies the next four highest-paid senior executives each received, on average, \$77 million in compensation during the 10 years—27% of it in stock options and 29% in stock awards. Yet since 2003 only three of the 10 largest repurchasers—Exxon Mobil, IBM, and Procter & Gamble—have outperformed the S&P 500 Index.

REFORMING THE SYSTEM

Buybacks have become an unhealthy corporate obsession. Shifting corporations back to a retain-and-reinvest regime that promotes stable and equitable growth will take bold action. Here are three proposals:

Put an end to open-market buybacks. In a 2003 update to Rule 10b-18, the SEC explained: “It is not appropriate for the safe harbor to be available when the issuer has a heightened incentive to manipulate its share price.” In practice, though, the stock-based pay of the executives who decide to do repurchases provides just this “heightened incentive.” To correct this glaring problem, the SEC should rescind the safe harbor.

A good first step toward that goal would be an extensive SEC study of the possible damage that open-market repurchases have done to capital formation, industrial corporations, and the U.S. economy over the past three decades. For example, during that period the amount of stock taken out of the market has exceeded the amount issued in almost every year; from 2004 through 2013 this net withdrawal averaged \$316 billion a year. In aggregate, the stock market is not functioning as a source of funds for corporate investment. As I’ve already noted, retained earnings have always provided the base for such investment. I believe that the practice of tying executive compensation to stock price is undermining the formation of physical and human capital.

Rein in stock-based pay. Many studies have shown that large companies tend to use the same set of consultants to benchmark executive compensation, and that each consultant recommends that the client pay its CEO well above average. As a result, compensation inevitably ratchets up over time. The studies also show that even declines in stock price increase executive pay: When a company’s stock price falls, the board stuffs even more options and stock awards into top executives’ packages, claiming that it must ensure that they won’t jump ship and will do whatever is necessary to get the stock price back up.

In 1991 the SEC began allowing top executives to keep the gains from immediately selling stock acquired from options. Previously, they had to hold the stock for six months or give up any “short-swing” gains. That decision has only served to reinforce top executives’ overriding personal interest in boosting stock prices. And because corporations aren’t required to disclose daily buyback activity, it gives executives the opportunity to trade, undetected, on inside information about when buybacks are being

THE TOP 10 STOCK REPURCHASERS

2003–2012

At most of the leading U.S. companies below, distributions to shareholders were well in excess of net income. These distributions came at great cost to innovation, employment, and—in cases such as oil refining and pharmaceuticals—customers who had to pay higher prices for products.

#1 EXXON MOBIL	#2 MICROSOFT	#3 IBM	#4 CISCO SYSTEMS	#5 PROCTER & GAMBLE
NET INCOME \$347B	NET INCOME \$148B	NET INCOME \$117B	NET INCOME \$64B	NET INCOME \$93B
REPURCHASES \$207B	REPURCHASES \$114B	REPURCHASES \$107B	REPURCHASES \$75B	REPURCHASES \$66B
DIVIDENDS \$80B	DIVIDENDS \$71B	DIVIDENDS \$23B	DIVIDENDS \$2B	DIVIDENDS \$42B
TOTAL \$287B 83% of NI	TOTAL \$185B 125% of NI	TOTAL \$130B 111% of NI	TOTAL \$77B 121% of NI	TOTAL \$108B 116% of NI
CEO PAY \$289M	CEO PAY \$12M	CEO PAY \$247M	CEO PAY \$297M	CEO PAY \$90M
% STOCK BASED 73%	% STOCK BASED 0%	% STOCK BASED 64%	% STOCK BASED 92%	% STOCK BASED 16%
\$211M	\$0*	\$158M	\$273M	\$14M

SOURCES STANDARD & POOR'S COMPUSTAT DATABASE; STANDARD & POOR'S EXECUCOMP DATABASE; THE ACADEMIC-INDUSTRY RESEARCH NETWORK.

NOTE THE PERCENTAGES OF STOCK-BASED PAY INCLUDE GAINS REALIZED FROM EXERCISING STOCK OPTIONS FOR ALL YEARS PLUS, FOR 2003–2005, THE FAIR VALUE OF RESTRICTED STOCK GRANTS OR, FOR 2006–2012, GAINS REALIZED ON VESTING OF STOCK AWARDS. ROUNDING TO THE NEAREST BILLION MAY AFFECT TOTAL DISTRIBUTIONS AND PERCENTAGES OF NET INCOME. *STEVEN BALLMER, MICROSOFT'S CEO FROM JANUARY 2000 TO FEBRUARY 2014, DID NOT RECEIVE ANY STOCK-BASED PAY. HE DOES, HOWEVER, OWN ABOUT 4% OF MICROSOFT'S SHARES, VALUED AT MORE THAN \$13 BILLION.

done. At the very least, the SEC should stop allowing executives to sell stock immediately after options are exercised. Such a rule could help launch a much-needed discussion of meaningful reform that goes beyond the 2010 Dodd-Frank Act's "Say on Pay"—an ineffectual law that gives shareholders the right to make nonbinding recommendations to the board on compensation issues.

But overall the use of stock-based pay should be severely limited. Incentive compensation should be subject to performance criteria that reflect investment in innovative capabilities, not stock performance.

Transform the boards that determine executive compensation. Boards are currently dominated by other CEOs, who have a strong bias toward ratifying higher pay packages for their peers. When approving enormous distributions to shareholders and stock-based pay for top executives, these directors believe they're acting in the interests of shareholders.

That's a big part of the problem. The vast majority of shareholders are simply investors in outstanding shares who can easily sell their stock when they want to lock in gains or minimize losses. As I argued earlier, the people who truly invest in the productive capabilities of corporations are taxpayers and workers. Taxpayers have an interest in whether a corporation that uses government investments can generate profits that allow it to pay taxes, which constitute the taxpayers' returns on those investments. Workers have an interest in whether the company will be able to generate profits with which it can provide pay increases and stable career opportunities.

It's time for the U.S. corporate governance system to enter the 21st century: Taxpayers and workers should have seats on boards. Their representatives

would have the insights and incentives to ensure that executives allocate resources to investments in capabilities most likely to generate innovations and value.

COURAGE IN WASHINGTON

After the Harvard Law School dean Erwin Griswold published "Are Stock Options Getting out of Hand?" in this magazine in 1960, Senator Albert Gore launched a campaign that persuaded Congress to whittle away special tax advantages for executive stock options. After the Tax Reform Act of 1976, the compensation expert Graef Crystal declared 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." It also happens that during the 1970s the share of all U.S. income that the top 0.1% of households got was at its lowest point in the past century.

The members of the U.S. Congress should show the courage and independence of their predecessors and go beyond "Say on Pay" to do something about excessive executive compensation. In addition, Congress should fix a broken tax regime that frequently rewards value extractors as if they were value creators and ignores the critical role of government investment in the infrastructure and knowledge that are so crucial to the competitiveness of U.S. business.

Instead, what we have now are corporations that lobby—often successfully—for federal subsidies for research, development, and exploration, while devoting far greater resources to stock buybacks. Here are three examples of such hypocrisy:

Alternative energy. Exxon Mobil, while receiving about \$600 million a year in U.S. government subsidies for oil exploration (according to the Center

#6 HEWLETT-PACKARD	#7 WALMART	#8 INTEL	#9 PFIZER	#10 GENERAL ELECTRIC
NET INCOME \$41B	NET INCOME \$134B	NET INCOME \$79B	NET INCOME \$84B	NET INCOME \$165B
REPURCHASES \$64B	REPURCHASES \$62B	REPURCHASES \$60B	REPURCHASES \$59B	REPURCHASES \$45B
DIVIDENDS \$9B	DIVIDENDS \$35B	DIVIDENDS \$27B	DIVIDENDS \$63B	DIVIDENDS \$87B
TOTAL \$73B 177% of NI	TOTAL \$97B 73% of NI	TOTAL \$87B 109% of NI	TOTAL \$122B 146% of NI	TOTAL \$132B 81% of NI
CEO PAY \$210M	CEO PAY \$189M	CEO PAY \$127M	CEO PAY \$91M	CEO PAY \$126M
% STOCK BASED 37% \$78M	% STOCK BASED 62% \$117M	% STOCK BASED 62% \$79M	% STOCK BASED 25% \$23M	% STOCK BASED 25% \$32M

for American Progress), spends about \$21 billion a year on buybacks. It spends virtually no money on alternative energy research.

Meanwhile, through the American Energy Innovation Council, top executives of Microsoft, GE, and other companies have lobbied the U.S. government to triple its investment in alternative energy research and subsidies, to \$16 billion a year. Yet these companies had plenty of funds they could have invested in alternative energy on their own. Over the past decade Microsoft and GE, combined, have spent about that amount annually on buybacks.

Nanotechnology. Intel executives have long lobbied the U.S. government to increase spending on nanotechnology research. In 2005, Intel's then-CEO, Craig R. Barrett, argued that "it will take a massive, coordinated U.S. research effort involving academia, industry, and state and federal governments to ensure that America continues to be the world leader in information technology." Yet from 2001, when the U.S. government launched the National Nanotechnology Initiative (NNI), through 2013 Intel's expenditures on buybacks were almost four times the total NNI budget.

Pharmaceutical drugs. In response to complaints that U.S. drug prices are at least twice those in any other country, Pfizer and other U.S. pharmaceutical companies have argued that the profits from these high prices—enabled by a generous intellectual-property regime and lax price regulation—permit more R&D to be done in the United States than elsewhere. Yet from 2003 through 2012, Pfizer funneled an amount equal to 71% of its profits into buybacks, and an amount equal to 75% of its profits into dividends. In other words, it spent more on buybacks and dividends than it earned and tapped its capital reserves to help fund them. The reality is, Americans pay high drug prices so that major pharmaceutical companies can boost their stock prices and pad executive pay.

GIVEN THE IMPORTANCE of the stock market and corporations to the economy and society, U.S. regulators must step in to check the behavior of those who are unable or unwilling to control themselves. "The mission of the U.S. Securities and Exchange Commission," the SEC's website explains, "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Yet, as we have seen, in its rulings on and monitoring of stock buybacks and executive pay over three decades, the SEC has taken a course of action contrary to those objectives. It has enabled the wealthiest 0.1% of society, including top executives, to capture the lion's share of the gains of U.S. productivity growth while the vast majority of Americans have been left behind. Rule 10b-18, in particular, has facilitated a rigged stock market that, by permitting the massive distribution of corporate cash to shareholders, has undermined capital formation, including human capital formation.

The corporate resource allocation process is America's 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 buyback and executive compensation binges will have to end. As with any addiction, there will be withdrawal pains. But the best executives may actually get satisfaction out of being paid a reasonable salary for allocating resources in ways that sustain the enterprise, provide higher standards of living to the workers who make it succeed, and generate tax revenues for the governments that provide it with crucial inputs. ♥

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William Lazonick is a professor of economics at the University of Massachusetts Lowell, the codirector of its Center for Industrial Competitiveness, and the president of the Academic-Industry Research Network. His book *Sustainable Prosperity in the New Economy? Business Organization and High-Tech Employment in the United States* won the 2010 Schumpeter Prize.