Innovative Enterprise and Sustainable Prosperity

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The three elements of sustainable prosperity

Stable and equitable economic growth = "sustainable prosperity"

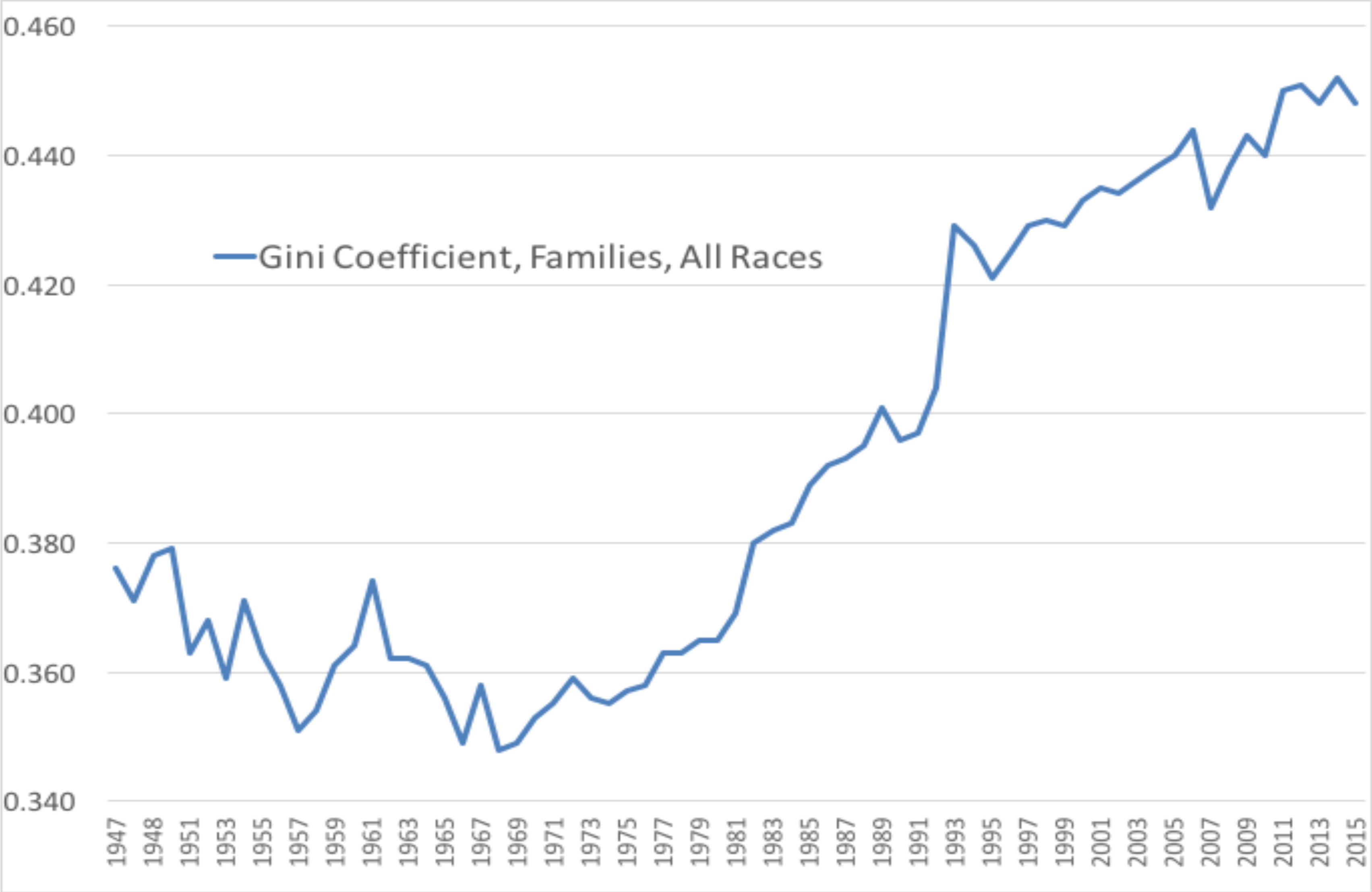
- **Growth:** real per capita productivity gains that can raise standards of living
- **that is stable:** employment and income that are not subject to boom and bust, over a working life of some four decades, with retirement income for two decades
- **that is equitable:** gains from growth shared fairly among those who contribute to it, at a point in time and over time (including equitable use of the planet's resources)

Unstable employment, inequitable income, and slow growth

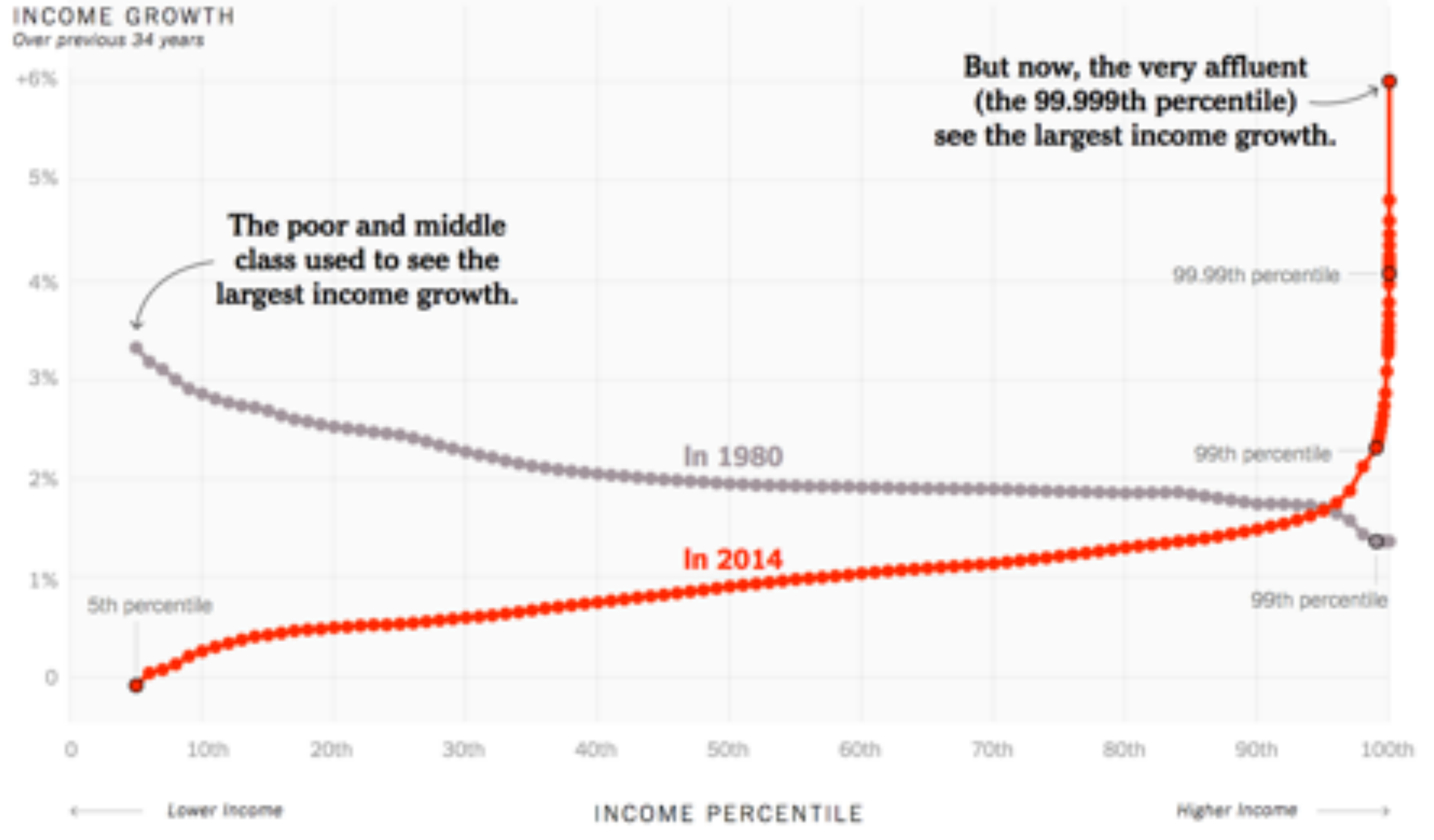
The economic performance of the United States is the antithesis of sustainable prosperity.

- **Unstable employment:** since the 1980s "middle class" employment opportunities with US business corporations have eroded
- **Inequitable income:** U.S. productivity gains have gone mainly to the richest households, with stagnating real incomes for most Americans
- **Slow productivity growth:** gains from innovation have been less forthcoming, even as the world faces major health and environmental challenges

Gini Coefficient for all families of all races in the United States, 1948-2015



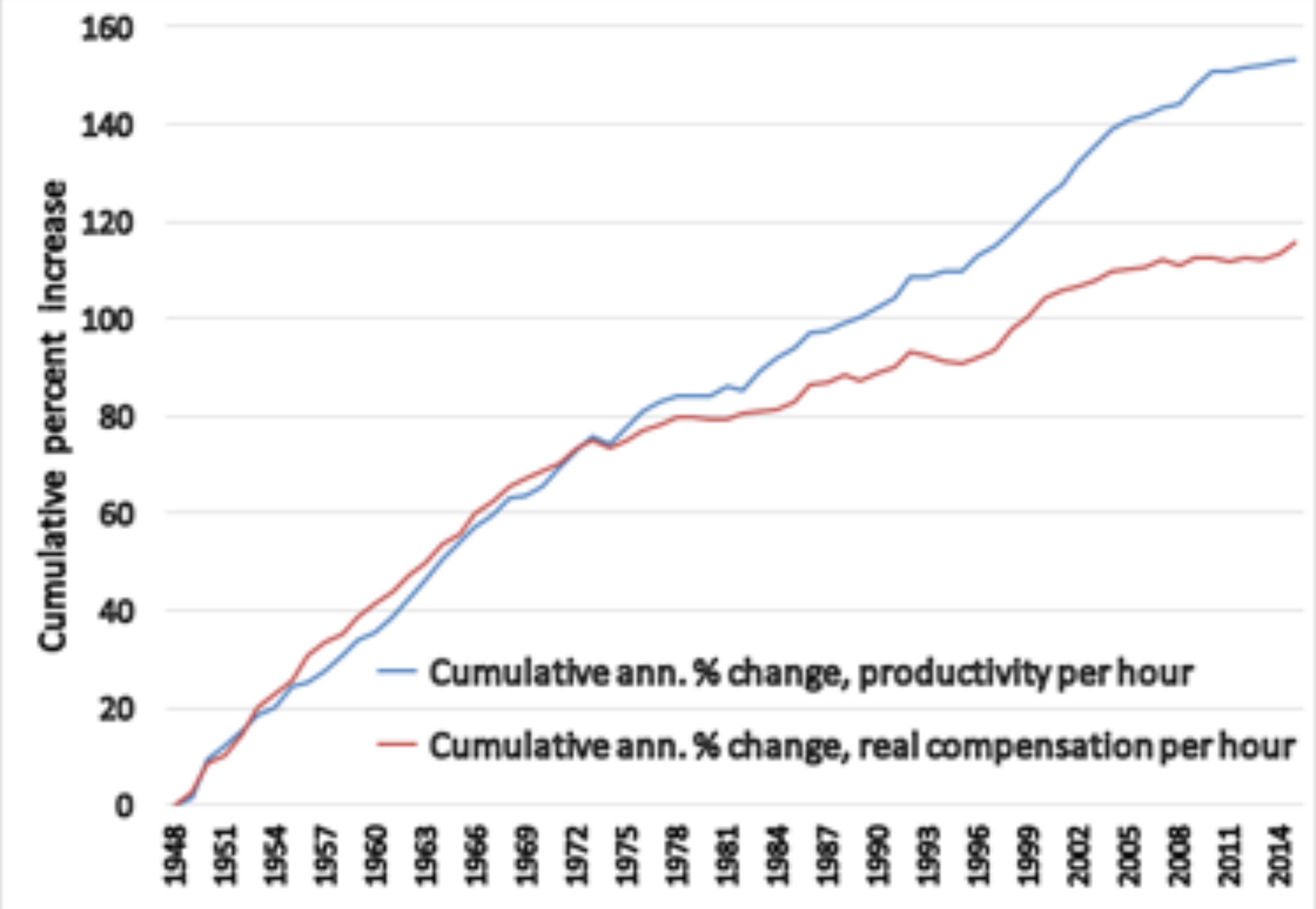
Two different eras of income growth



Note: Inflation-adjusted annual average growth using income after taxes, transfers and non-cash benefits.

Source: David Leonhardt, "Our broken economy, in one simple chart," New York Times, August 7, 2017, at https://www.nytimes.com/interactive/2017/08/07/opinion/leonhardt-income-inequality.html.

Cumulative annual percent changes in productivity per hour and real wages per hour, 1948-2015



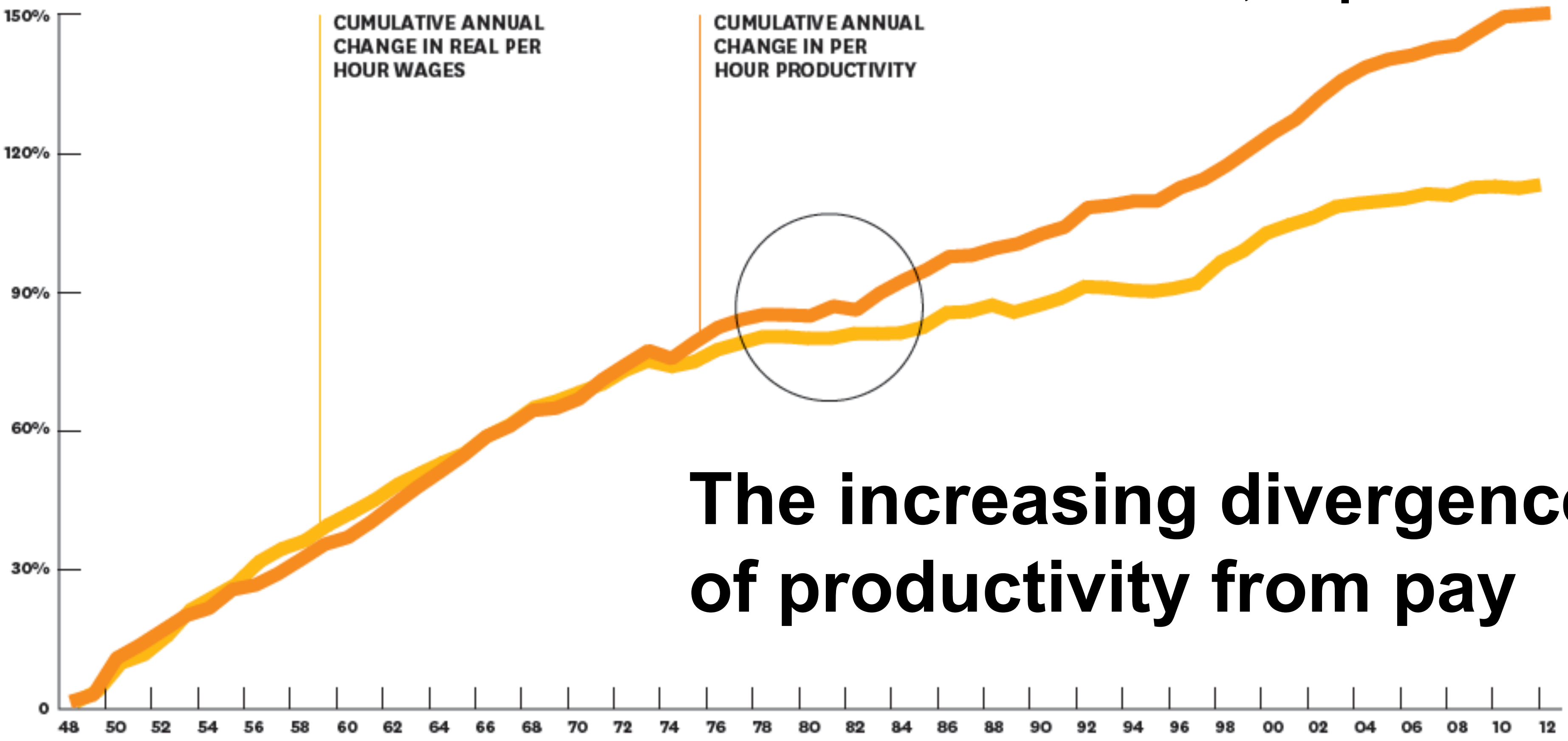
profits without prosperity

STOCK BUYBACKS MANIPULATE THE MARKET AND LEAVE MOST AMERICANS WORSE OFF.

Harvard Business Review, Sept. 2014

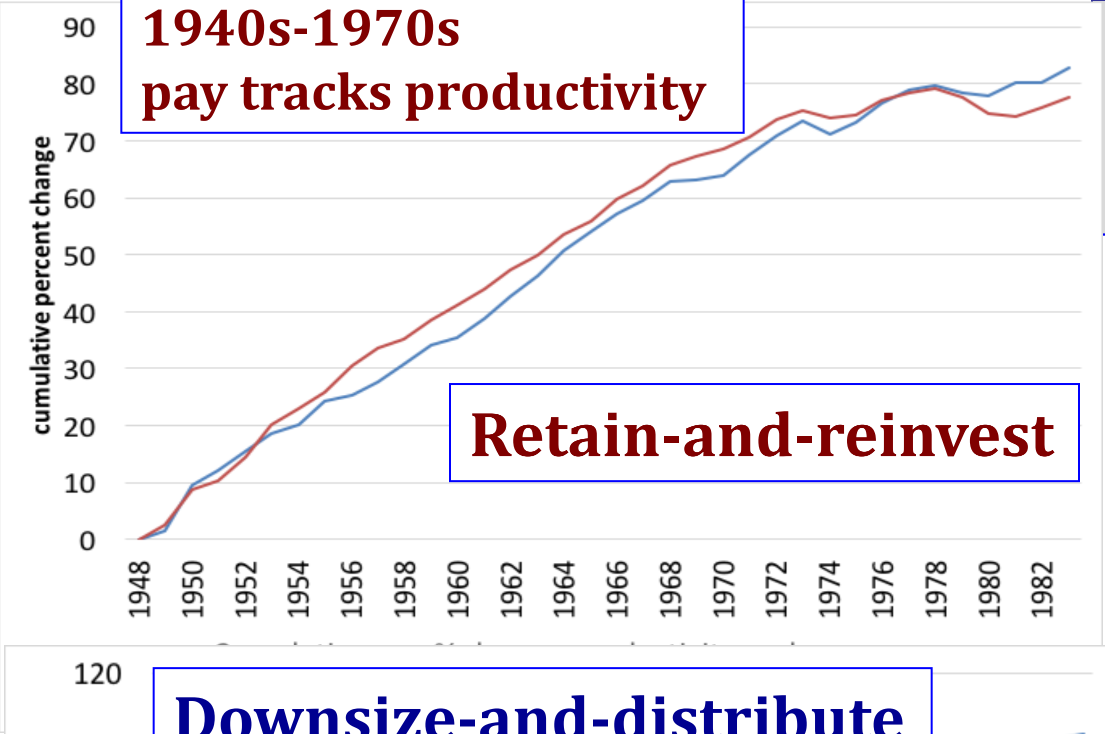
WHEN PRODUCTIVITY AND WAGES PARTED WAYS

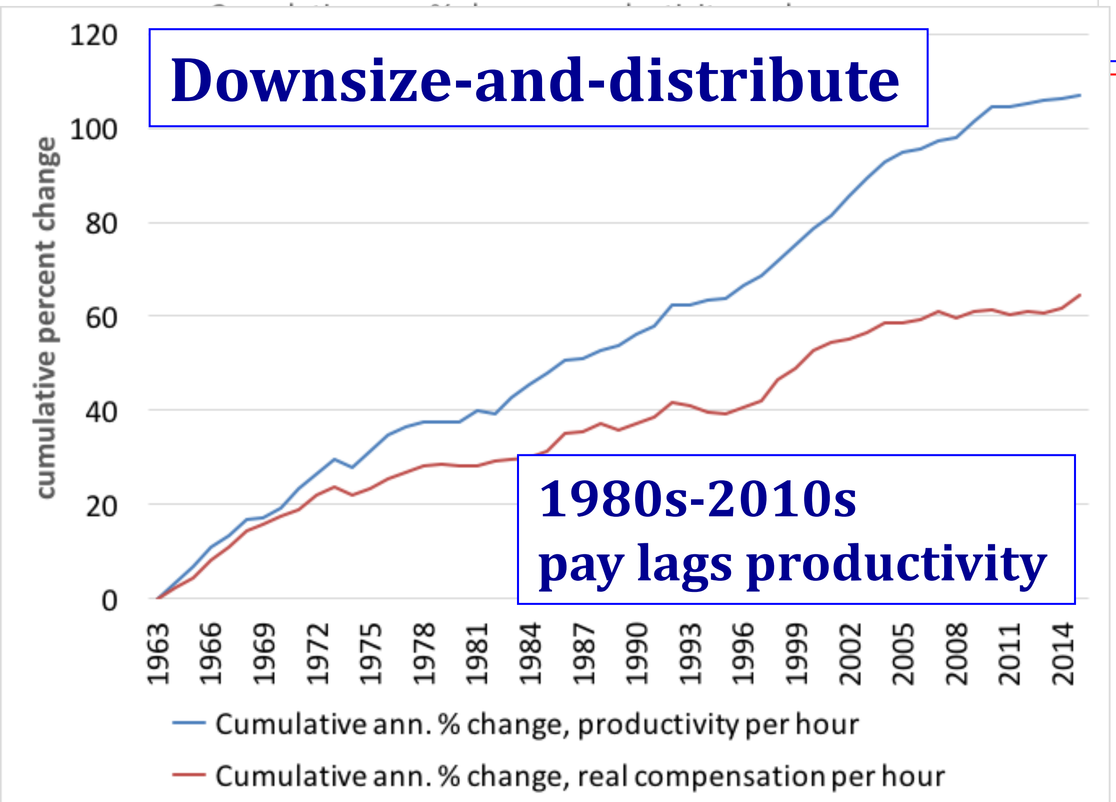
From 1948 to the mid-1970s, increases in productivity and wages went hand in hand. Then a gap opened between the two.



SOURCE ECONDATAUS.COM/WAGEGAP12.HTML

The increasing divergence of productivity from pay





Career employment: Key driver of the productivity-pay relation

Old Economy Business Model

Career-with-one-company norm: employees share in profits through job security, pay raises, defined-benefit pensions, and health coverage

Source: Bureau of Labor Statistics

New Economy Business Model

Insecure jobs, globalized labor, defined-contribution pensions

Massive stock buybacks and exploding top executive pay

Erosion of middle-class employment opportunities as careers in companies disappear

Stock buybacks and the transformation of U.S. corporate resource allocation

BROOKINGS

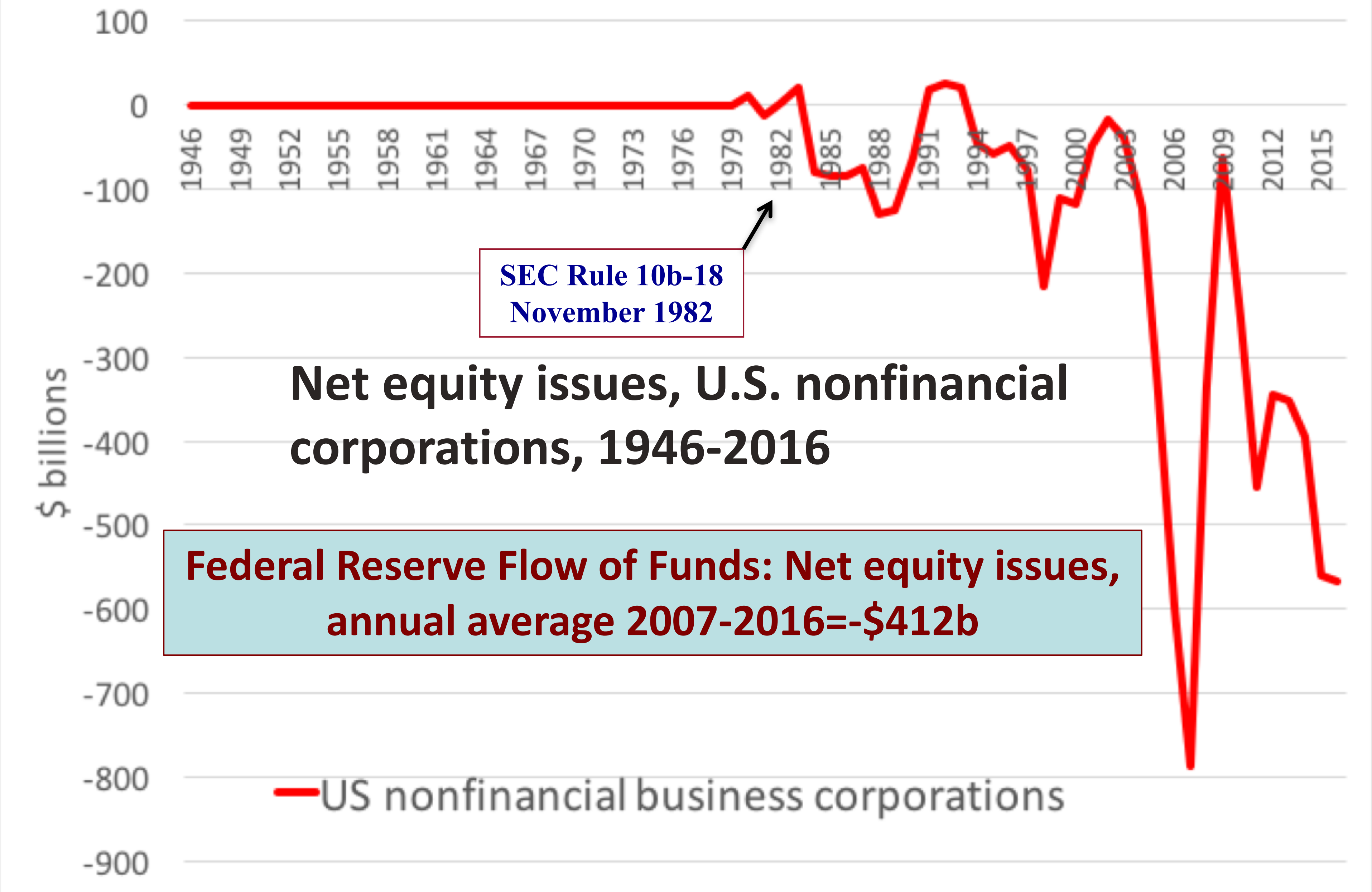
Paper | April 17, 2015

Stock buybacks: From retain-and reinvest to downsize-and-distribute

By: William Lazonick

Stock buybacks are an important explanation for both the concentration of income among the richest households and the disappearance of middle-class employment opportunities in the United States over the past three decades. Over this period, corporate resource-allocation at many, if not most, major U.S. business corporations has transitioned from "retain-and-reinvest" to "downsize-and-distribute," says William Lazonick in a new paper.

The looting of the US industrial corporation

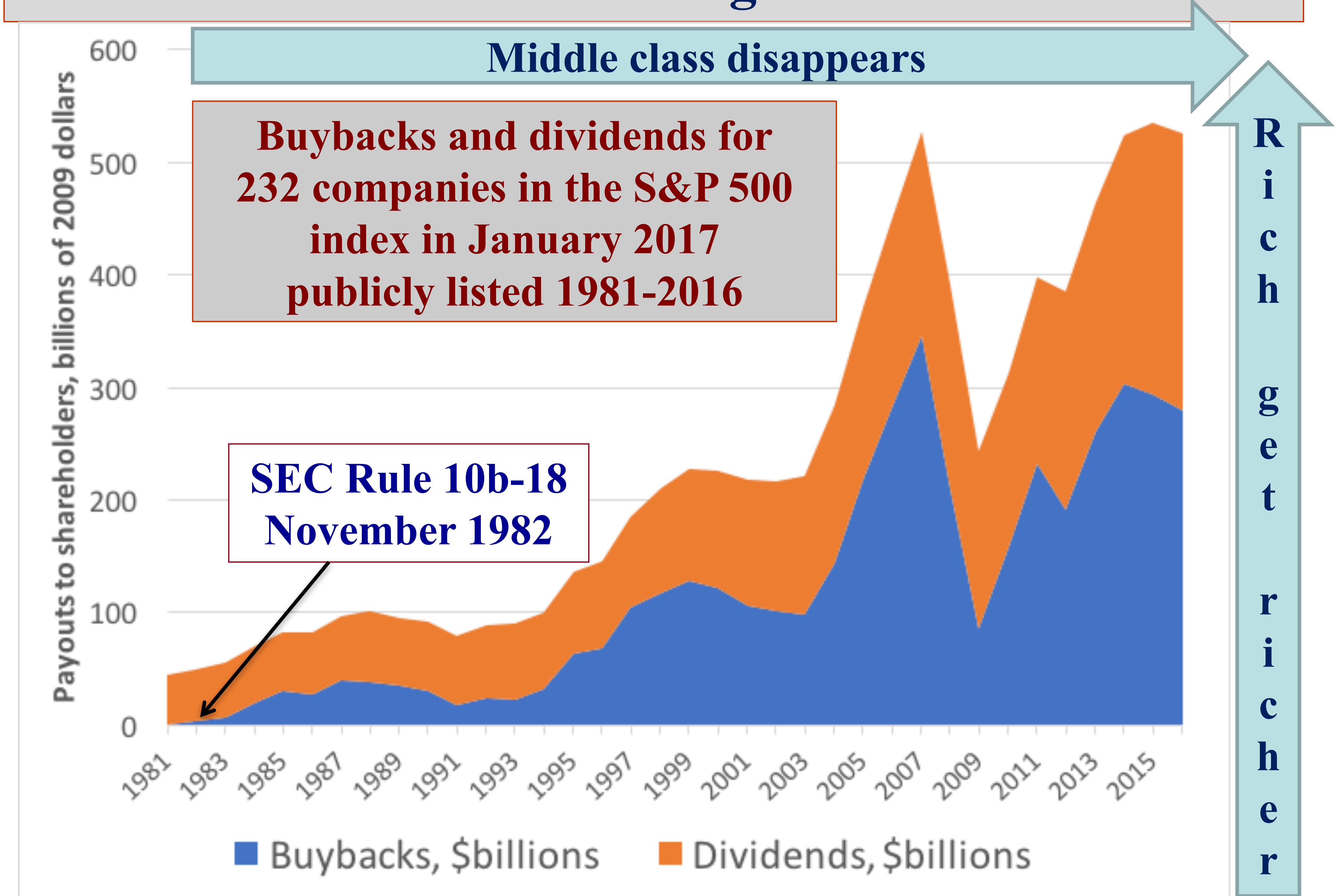


The era of downsize-and-distribute: The U.S. corporate economy is a "buyback economy"

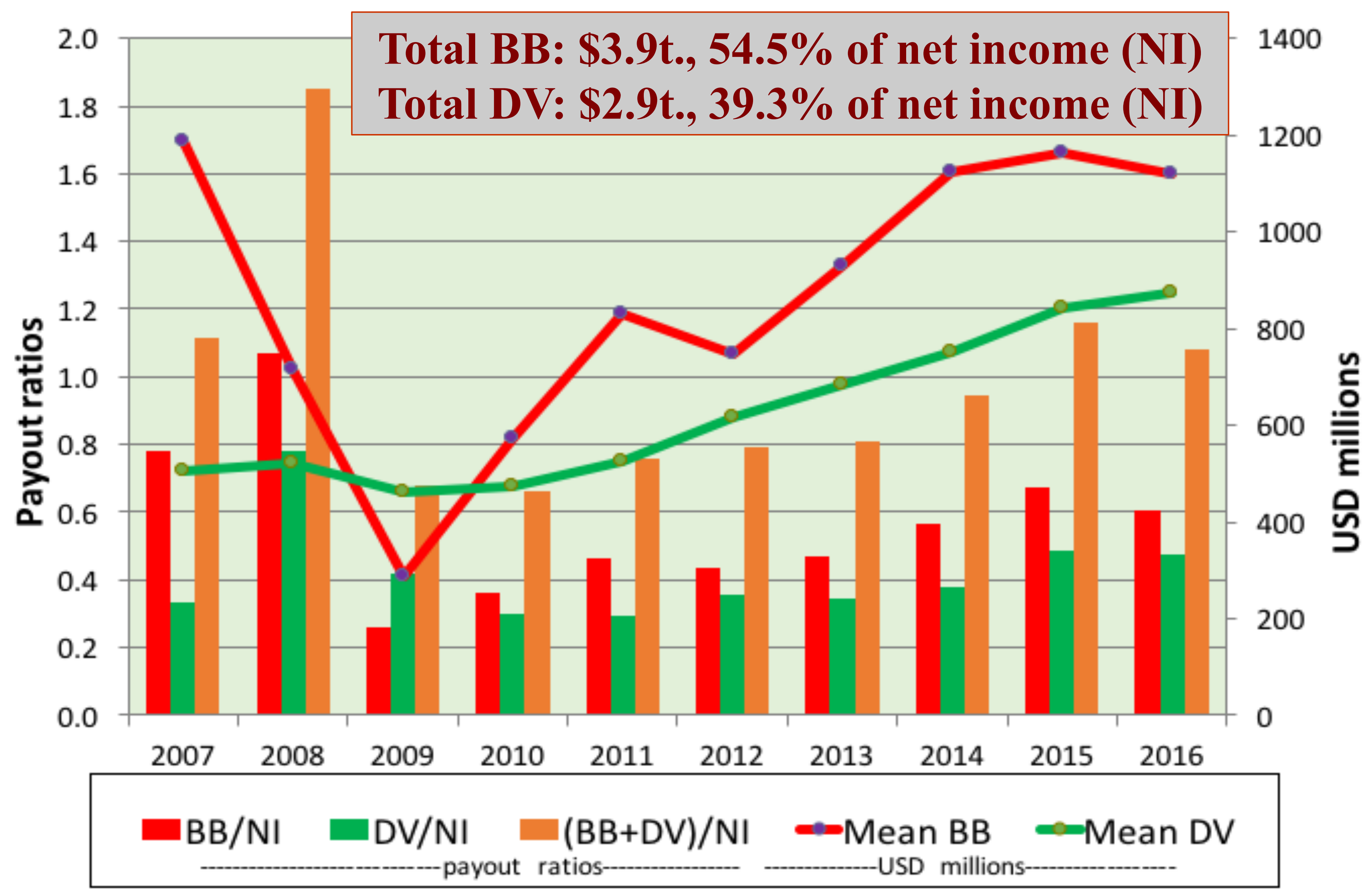
	Net equity issues, U.S. non-financial corporations 2015$ billions	Net equity issues as % of GDP
1946-1955	143.2	0.56
1956-1965	110.9	0.30
1966-1975	316.0	0.58
1976-1985	-290.9	-0.40
1986-1995	-1,002.5	-1.00
1996-2005	-1,524.4	-1.09
2006-2015	-4,466.6	-2.65

Net equity issues, industrial corps. 2016=-$568b.

In the name of "maximizing shareholder value"



Buybacks (BB) and dividends (DV) by 461 companies in the S&P 500 Index in January 2017 that were publicly listed 2007-2016



LARGEST REPURCHASERS 2007-2016

RANK	Company Name	Ticker Symbol	NI, $b	BB, $b	DV, $b	BB/NI %	DV/NI %	(BB+DV)/ NI%
1	EXXON MOBIL	XOM	311	178	98	57	32	89
2	APPLE	AAPL	271	133	47	49	17	66
3	MICROSOFT	MSFT	178	120	66	68	37	104
4	IBM	IBM	137	115	36	84	27	111
5	WAL-MART	WMT	150	67	51	45	34	79
6	CISCO SYSTEMS	CSCO	81	63	18	78	22	100
7	GENERAL ELECTRIC	GE	128	62	86	48	67	116
8	PFIZER	PFE	86	61	68	71	79	150
9	PROCTER & GAMBLE	PG	108	60	59	55	55	111
10	ORACLE	ORCL	86	57	15	67	17	84
11	HEWLETT-PACKARD	HPQ	44	57	9	130	22	151
12	INTEL	INTC	95	52	39	54	41	96
13	HOME DEPOT	HD	48	51	21	106	44	150
14	AIG	AIG	-54	48	7	-88	-13	-101
15	GOLDMAN SACHS	GS	78	48	15	62	20	81
16	WELLS FARGO	WFC	162	47	53	29	33	62
17	DISNEY	DIS	58	46	13	80	22	101
18	JPMORGAN CHASE	JPM	177	46	54	26	31	57
19	AT&T	T	119	45	99	37	83	121
20	JOHNSON & JOHNSON	JNJ	131	45	65	34	50	84
21	MCDONALD'S	MCD	47	42	26	89	56	146
22	GILEAD SCIENCES	GILD	61	37	4	61	7	68
23	PEPSICO	PEP	61	36	32	59	53	112
24	CONOCOPHILLIPS	COP	40	35	30	88	75	163
25	CHEVRON	CVX	173	35	65	20	38	58

The damage that buybacks do: Concentrate income at the top while failing to invest in the middle class

Institute for
New Economic Thinking

WORKING PAPER

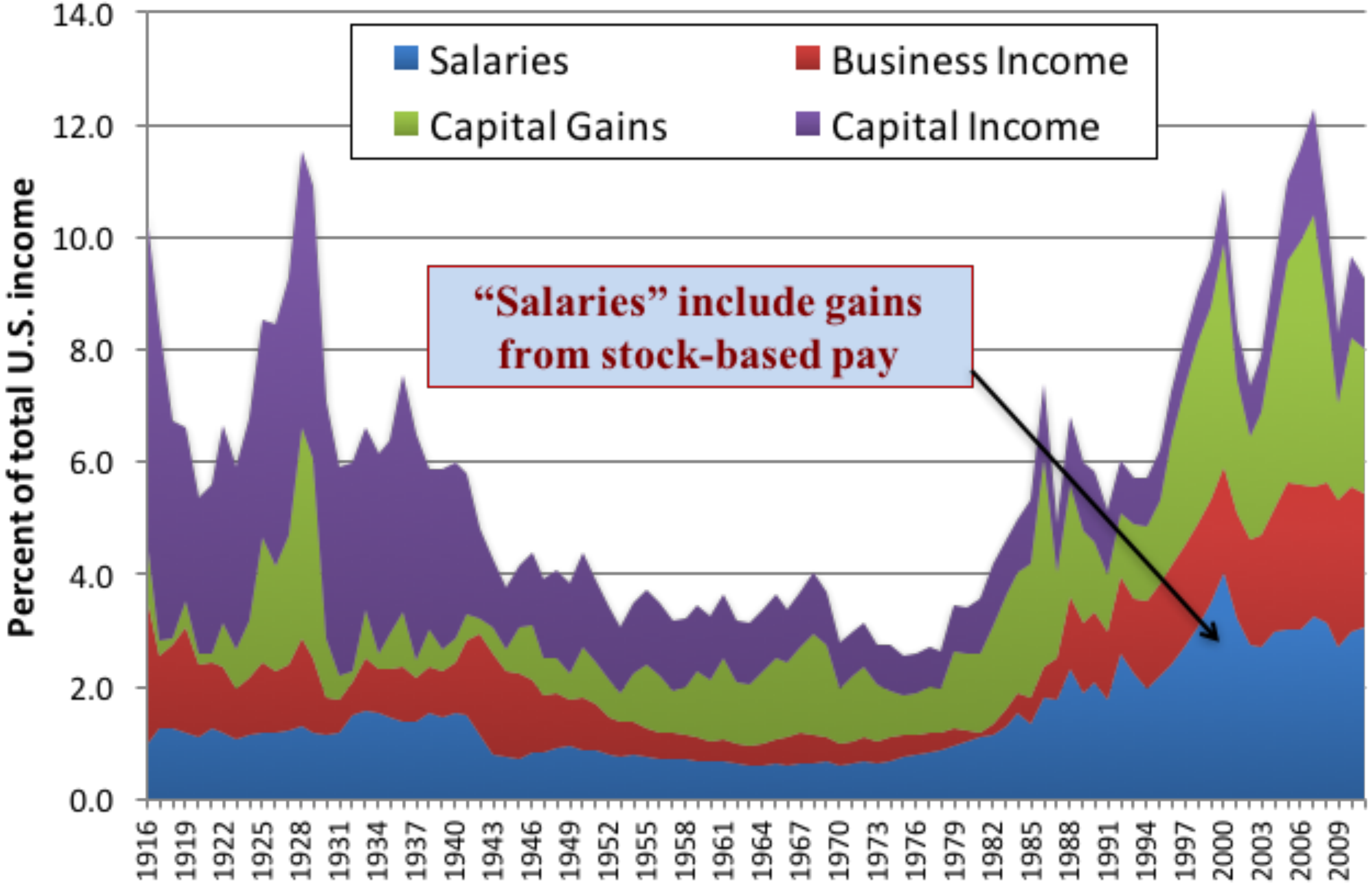
William Lazonick

JAN 2015

Labor in the Twenty-First Century: The Top 0.1% and the Disappearing Middle-Class

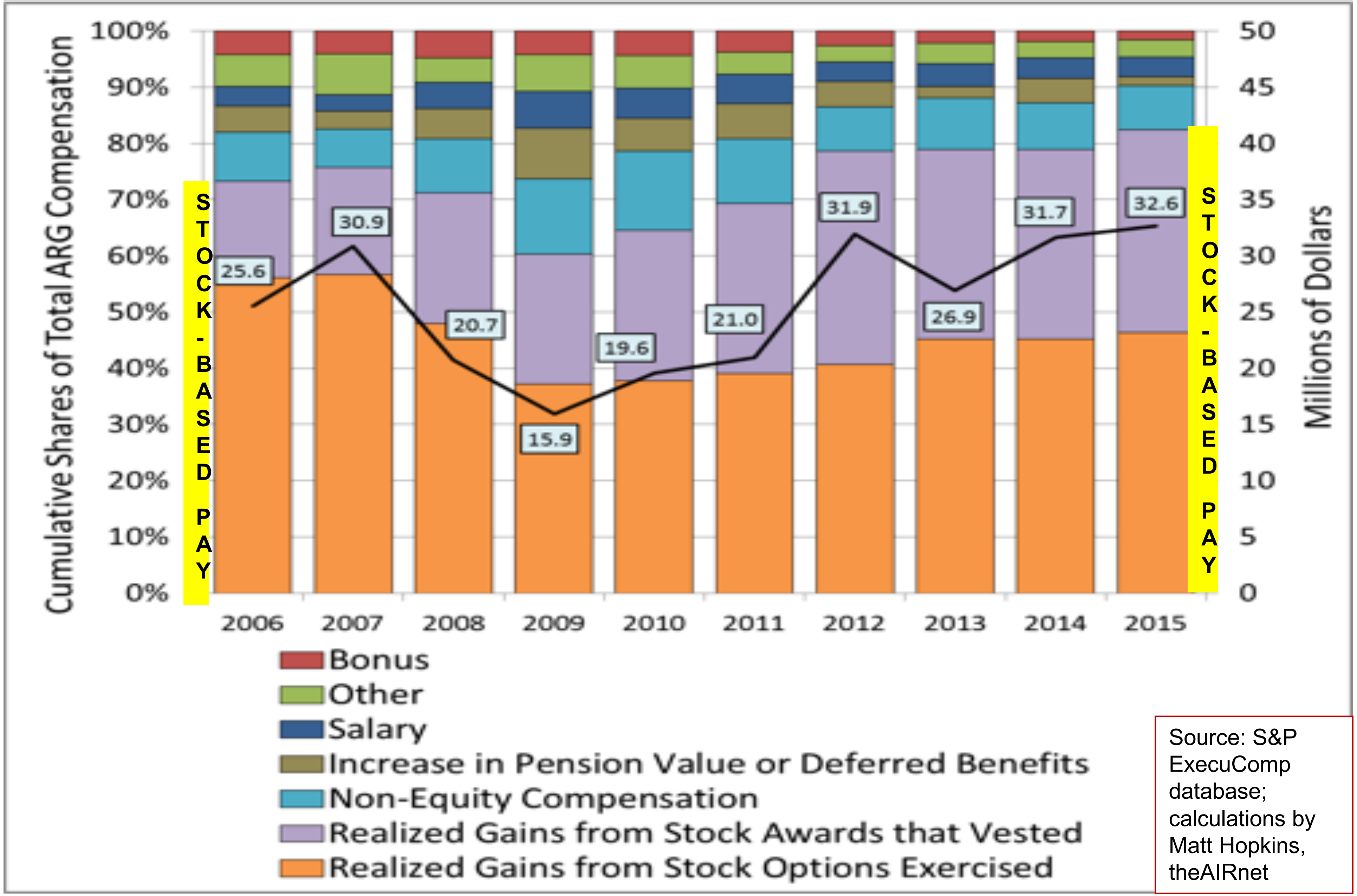
The ongoing explosion of the incomes of the richest households and the erosion of middle-class employment opportunities for most of the rest have become integrally related in the now-normal operation of the U.S. economy.

“Salaried” incomes of the top 0.1%, 1916-2011



http://topincomes.parisschoolofeconomics.eu/#Database: United States, Top 0.1% income composition.

Average total pay by ACTUAL REALIZED GAINS and % shares of pay components, 500 highest paid US executives in each year, 2006-2015



Source: S&P ExecuComp database; calculations by Matt Hopkins, theAIRnet

And the top hedge-fund managers make even more: Comparative remuneration, corp. execs. and HFMs, 2014

	Corporate Executives	Pay	Hedge Fund Managers	Pay
1	David A. Ebersman Facebook	$388 M	Kenneth Griffin Citadel	$1.3 B
2	Leslie Moonves, II CBS Corp	$259 M	James Simons Renaissance Technologies	$1.2 B
3	Sumner M. Redstone CBS Corp	$225 M	Raymond Dalio Bridgewater Associates	$1.1 B
4	Leonard Bell, M.D. Alexion Pharmaceuticals	$196 M	William Ackman Pershing Square Capital Management	$950 M
5	John C. Martin, Ph.D. Gilead Sciences	$193 M	Israel (Izzy) Englander Millennium Management	$900 M
6	Timothy D. Cook Apple	$154 M	Michael Platt BlueCrest Capital Management	$800 M
7	Sumner M. Redstone Viacom	$120 M	Larry Robbins Glenview Capital Management	$570 M
8	David M. Zaslav Discovery Comm	$118 M	David Shaw D.E. Shaw Group	$530 M
9	Martin Ellis Franklin Jarden Corp	$118 M	O. Andreas Halvorsen Viking Global Investors	$450 M
10	Reed Hastings Netflix	$117 M	Charles (Chase) Coleman III Tiger Global Management	$425 M
	Average	**$189 M**	**Average**	**$822 M**

Remuneration of the top 15 hedge-fund managers, USA, 2016 (top15 average=$606 million)

Name	Hedge Fund	Take-Home Pay
James Simons	Renaissance Technologies	$1.5 billion
Michael Platt	BlueCrest Capital Management	$1.5 billion
Raymond Dalio	Bridgewater Associates	$1.4 billion
David Tepper	Appaloosa Management	$750 million
Kenneth Griffin	Citadel LLC	$500 million
Daniel Loeb	Third Point	$400 million
Paul Singer	Elliott Management	$400 million
David Shaw	D. E. Shaw & Co.	$400 million
John Overdeck	Two Sigma Investments	$375 million
David Siegel	Two Sigma Investments	$375 million
Michael Hintze	CQS LLP	$325 million
Jeffrey Talpins	Element Capital Management	$300 million
Stanley Druckenmiller	Duquesne Family Office	$300 million
Brett Icahn	Icahn Capital Management	$280 million
David Schechter	Icahn Capital Management	$280 million

https://www.forbes.com/sites/nathanvardi/2017/03/14/hedge-fund-managers/#289eb5386e79

The damage that buybacks do: Undermining the foundation of corporate finance

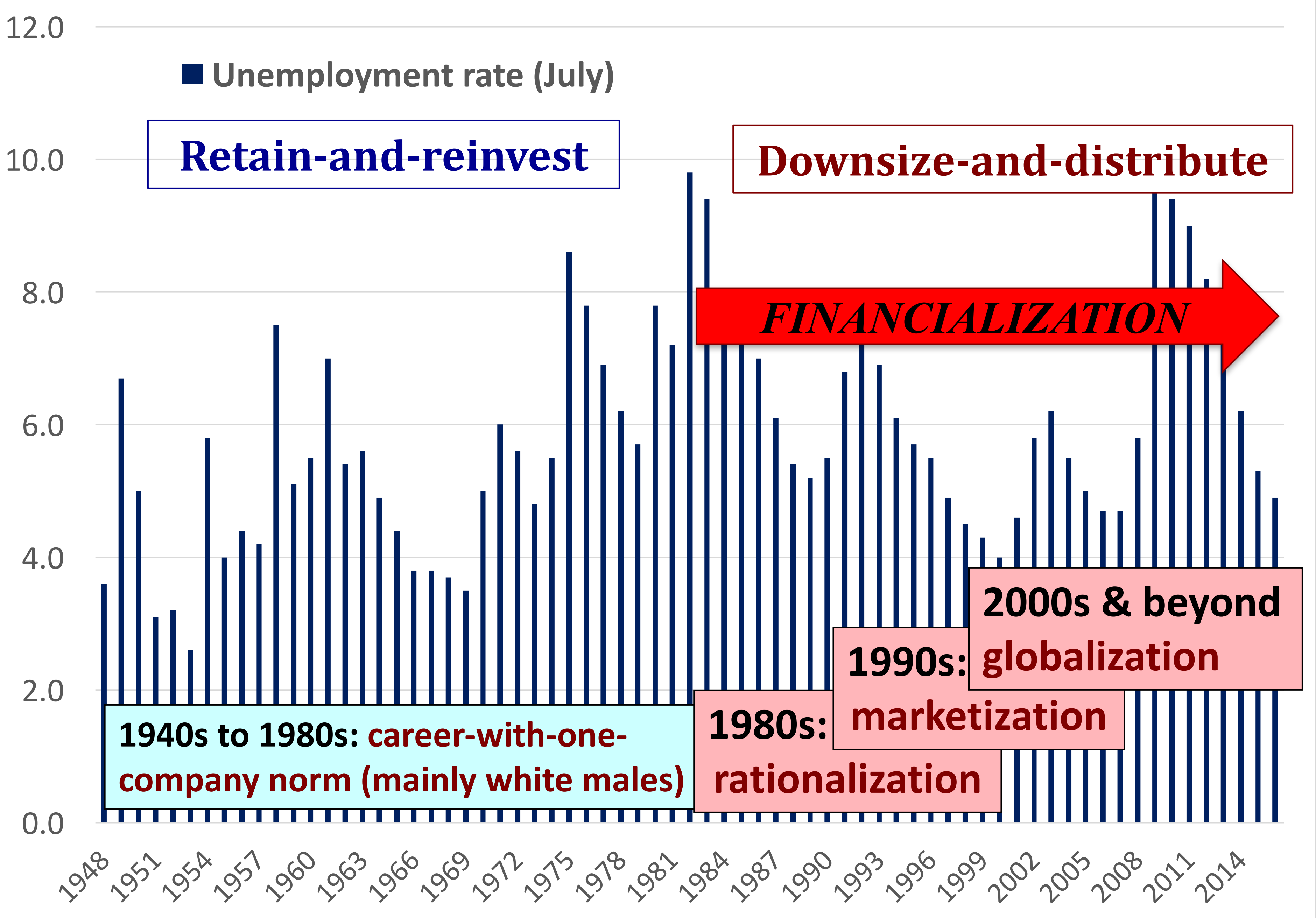
Retained earnings are the foundation for investment in the productive capabilities of the firm.

Companies invest in

- Plant and Equipment (P&E)
- Research and Development (R&D)
- Training and Retaining (T&R), espec. “on-the-job”

Until the 1980s, executives and economists worried that dividend payouts might be too high to sustain the growth of the firm. Since the mid-1980s, in the name of “maximizing shareholder value,” that concern has (literally) “gone by the board.”

The disappearing middle class



Three sources of structural change in US corporate employment relations since the 1980s

1980s: Rationalization: permanent layoffs of blue-collar workers

1990s: Marketization: end of the career-with-one company norm

2000s: Globalization: international flows of jobs to labor and labor to jobs

- All three transformations in employment resulted in the erosion of "middle-class" jobs in the United States
- But the corporations that had employed these people did not disappear, and many remained or became highly profitable

Q. Why didn't US corporations invest the gains from rationalization, marketization, and globalization in the next generation of higher quality jobs?

A. Financialization of corporate resource allocation (i.e., buybacks)

Large corporations dominate the US economy
Economic performance depends on corporate resource allocation

2012			Percent of US business total			
			Firms	Employees	Payroll	Revenue
No. of emplo-yees	No of firms	Average employees	%	%	%	%
All sizes	5,726,120	20	100.00	100	100.0	100.0
500 +	18,219	3,286	0.32	52	58	64
5,000+	1,909	20,366	0.03	34	38	44
10,000+	964	33,542	0.02	27	31	36

- Less than 1,000 firms with 10,000+ employees have a huge influence on US economic performance.
- How senior executives decide to allocate corporate resources affects employment, productivity and pay.

https://www.census.gov/econ/susb/data/susb2007.html (most recent data)

Separation of share ownership and managerial control

See W. Lazonick, "The Functions of the Stock Market and the Fallacies of Shareholder Value," INET WP, 2017.

- **In the growth of the U.S. economy, the key function of the stock market was *control:* the stock market promoted innovative enterprise by separating managerial control over corporate resource allocation from ownership of the company's shares.**

- **Erroneously assuming, however, that the stock market's function is cash—and that *control* is the "original sin" of US corporations—agency theorists argue that, for the sake of economic efficiency, shareholders as "principals" must compel managers as "agents" to "maximize shareholder value" (MSV)**

“Agency theorists” view the business enterprise as a “market imperfection”, in need of the MSV solution

- **MSV: rooted in neoclassical theory, with business enterprise as a massive market imperfection, reflecting “inefficient” capital markets**
- **Critical assumption of agency theory: all economic participants receive guaranteed market returns except for *shareholders who bear risk by making investments without guaranteed returns***
- **It is then assumed that this risk-bearing function results in a more efficient economy**
- **It follows that those who bear risk should control the allocation of the economy’s resources**

Jensen: “Disgorge” the “free” cash flow

Solution to the agency problem:

To make markets efficient, *“disgorge free cash flow”:*

“Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below cost or wasting it on organization inefficiencies.”

Michael C. Jensen, *American Economic Review*, 1986.

What it means to “disgorge” the “free” cash flow

DISGORGE: Implication that the cash that is under corporate control is ill-gotten—but agency theory lacks a theory of the productive (i.e., innovative) enterprise

Whose cash is it that is being disgorged?

FREE CASH FLOW: Lay off, say, 5,000 employees who generated the firm’s revenue-generating products—and increase the cash flow that is “free”
Or avoid corporate taxes to make more cash flow “free”
Or price-gouge customers to create more “free cash flow”

Integral to disgorging corporate cash is the alignment of the interests of managers as agents with shareholders as principals by ***giving managers stock-based pay.***

Economic critique of MSV

- **Fundamental problem with MSV: erroneous assumption that shareholders are the only actors who invest without a guaranteed return**
- **NOT SO: *Taxpayers* through government agencies and *workers* through business employers regularly make risky investments in productive capabilities. From this perspective, both the state and labor have economic claims on profits if and when they occur.**
- **Irony of MSV: public shareholders typically never invest in the company's value-creating capabilities. They invest in outstanding shares, hoping for a rise in price. Following MSV, executives fuel this hope by "disgorging" cash as dividends and buybacks.**

MSV is a theory of value extraction, not value creation

- **Economic activity and performance depend on resource allocation decisions**
- **We rely on corporate executives to make resource allocation decisions**
- **Stock-based compensation enriches top corporate executives in the name of MSV, and gives them incentives to encourage speculation in and engage in manipulation of the price of their company's stock**
- **Stock buybacks: The prime mode of corporate resource allocation for the purpose of manipulating stock prices**

Milton Friedman's clarion call for MSV

Milton Friedman, "The social responsibility of business is to increase its profits" *NYT Magazine*, Sept. 13, 1970.

"In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. 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 while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."

Friedman concludes the article by quoting himself from his 1962 book *Capitalism and Freedom*: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

from the pdf of Friedman's actual article
***New York Times*, September 13, 1970**

A Friedman doctrine—

The Social Responsibility Of Business Is to Increase Its Profits

By MILTON FRIEDMAN

TAMING G.M.—Chairman James Roche of General Motors (right) replies to members of Campaign G.M. (below, wearing "Tame G.M." buttons) at the corporation's stockholders' meeting in May. Representatives of the campaign demanded that G.M. name three new directors to represent "the public interest" and set up a committee to study the company's performance in such areas of public concern as safety and pollution. The stockholders defeated the proposals overwhelmingly, but management, apparently in response to the second demand, recently named five directors to a "public-policy committee." The author calls such drives for social responsibility in business "pure and unadulterated socialism," adding: "Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society."

"Campaign GM" demands that GM address car safety and environmental pollution

In the photo from GM's shareholder meeting in May 1970, Roche was replying to members of Campaign G.M., an organization that

"demanded that G.M. name three new directors to represent 'the public interest' and set up a committee to study the company's performance in such areas of public concern as safety and pollution. The stockholders defeated the proposals overwhelmingly, but management, apparently in response to the second demand, recently named five directors to a "public-policy committee." The author [Milton Friedman] calls such drives for social responsibility in business "pure and unadulterated socialism," adding: "Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of free society."

Campaign GM organizers, wearing "Tame GM" buttons

Jerome Kretchmer, New York Environmental Protection Administrator.

Betty Furness, consumer-affairs adviser in the Johnson Administration.

Philip Sorenson, chairman of Campaign G.M.'s parent organization.

John Esposito, lawyer and coordinator of Campaign G.M.

Joseph Onek, lawyer and a founder of Campaign G.M.

Barbara Williams, a law student at U.C.L.A.

Robert Townsend, the author of "Up the Organization."

The Rev. Channing Phillips, a civil-rights activist.

New York Times (1923-Current file); May 1, 1970; ProQuest Historical Newspapers: The New York Times
pg. 13

13 in House Back Drive to Put Public Members on G.M. Board

By EILEEN SHANAHAN
Special to The New York Times

WASHINGTON, April 30 — Five black members of the House of Representatives and eight more members from the New York City area endorsed in separate statements today a drive to elect representatives of the public to the board of the General Motors Corporation.

The black Representatives, led by Shirley Chisholm of Brooklyn, endorsed in particular the nomination to the General Motors board of the Rev. Channing E. Phillips, a Negro minister, who is the Democratic National Committeeman for the District of Columbia.

"For too long, black men have been systematically excluded from decision-making in American corporations," the statement of the black members of Congress said. "Of the top 25 U.S. Corporations, not one has a black person on its board of directors."

The group charged that General Motors had been "unresponsive to the needs of black Americans."

General Motors officials in Washington could not be reached for comment.

Besides Representative Chisholm, other members of the House who signed the statement were Representatives William Clay of Missouri, Charles C. Diggs Jr. of Michigan, Augustus F. Hawkins of California and Louis Stokes of Ohio. All are Democrats.

Separate statements supporting not only the drive to elect public directors of General Motors but also other proposals that will come before a stockholders' meeting next month were issued by Representative James H. Scheuer of the Bronx and seven more New York area Representatives.

Mr. Scheuer, who holds a degree from the Harvard School of Business Administration, said he had written the trustees of Harvard University, asking that the school vote its 287,000 shares of stock in favor of all the proposals advanced by a group called the Campaign to

Shirley Chisholm: Willing to Speak Out

By CHARLAYNE HUNTER

New York Times May 22, 1970

As one of the nine blacks in the House, Mrs. Chisholm has joined with the others on several issues, including "the campaign to make General Motors responsible" by, among other things, electing a black man to the company's board.

Milton Friedman tells US corporations how **NOT** to be innovative in global competition

The photo of Roche and the editorializing on it, points out that, in historical retrospect, the demands of Campaign G.M. for safer and less polluting cars were in effect demands for GM to engage in automobile innovation. In the 1970s and beyond, the world leaders in producing these "socially responsible" cars would be Japanese and European companies, leaving the "profit-maximizing" General Motors lagging further and further behind.

What Friedman (and, quoting him, the *New York Times* editor) called "pure and unadulterated socialism" proved to be the future of the innovative automobile industry!

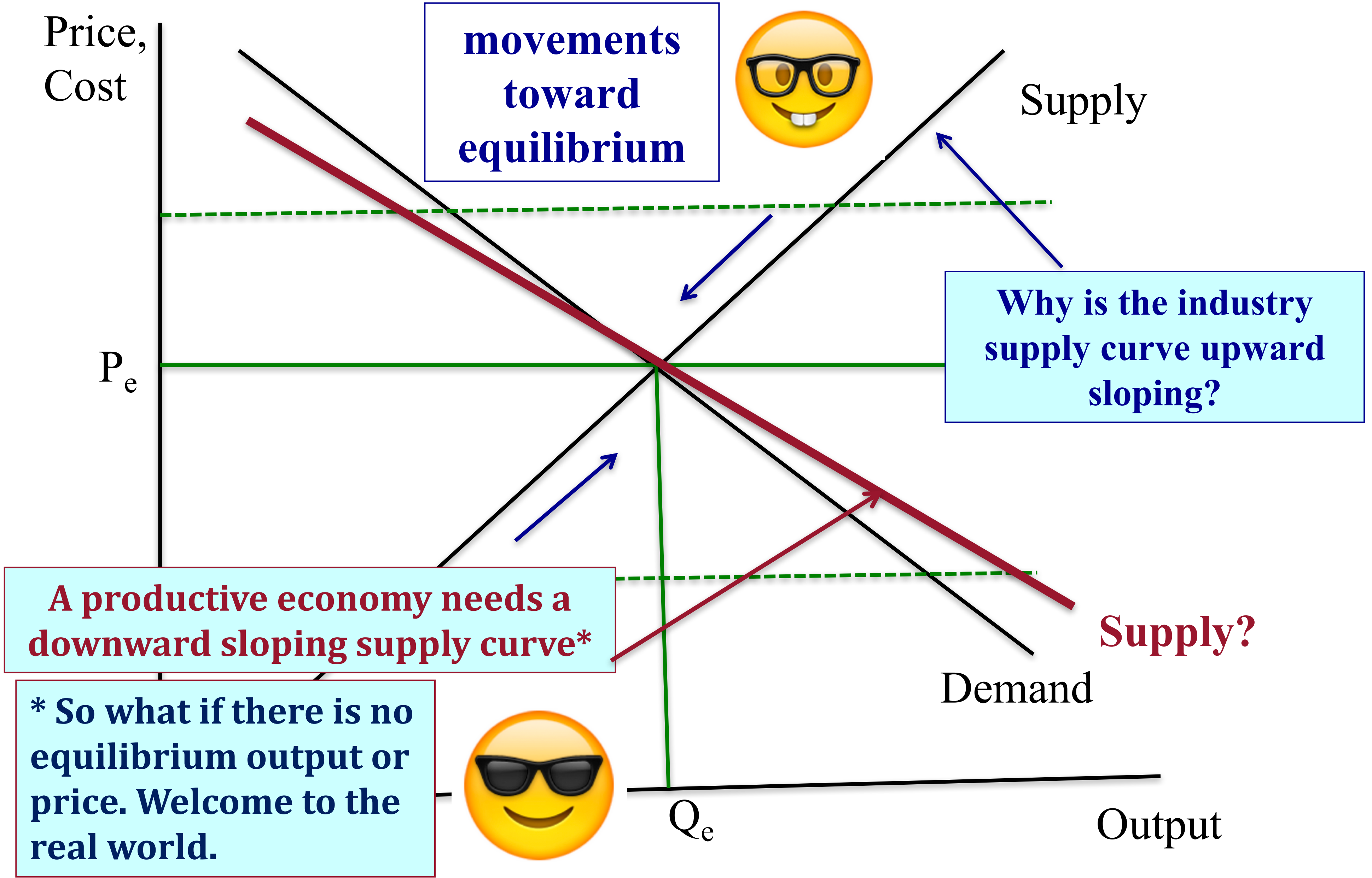
How did agency theorists get it so wrong?

- They are "well-trained" neoclassical economists: they posit that <u>the most unproductive business firm is the foundation for the most efficient economy</u>

- They view the large-scale business enterprise as a massive "market imperfection"; *not* as a value-creating, i.e., innovative, social organization that must distribute gains to value creators and defend itself from value extractors

- With their training in "the myth of the market economy", even progressive economists have been blind to the looting of the US industrial corporation

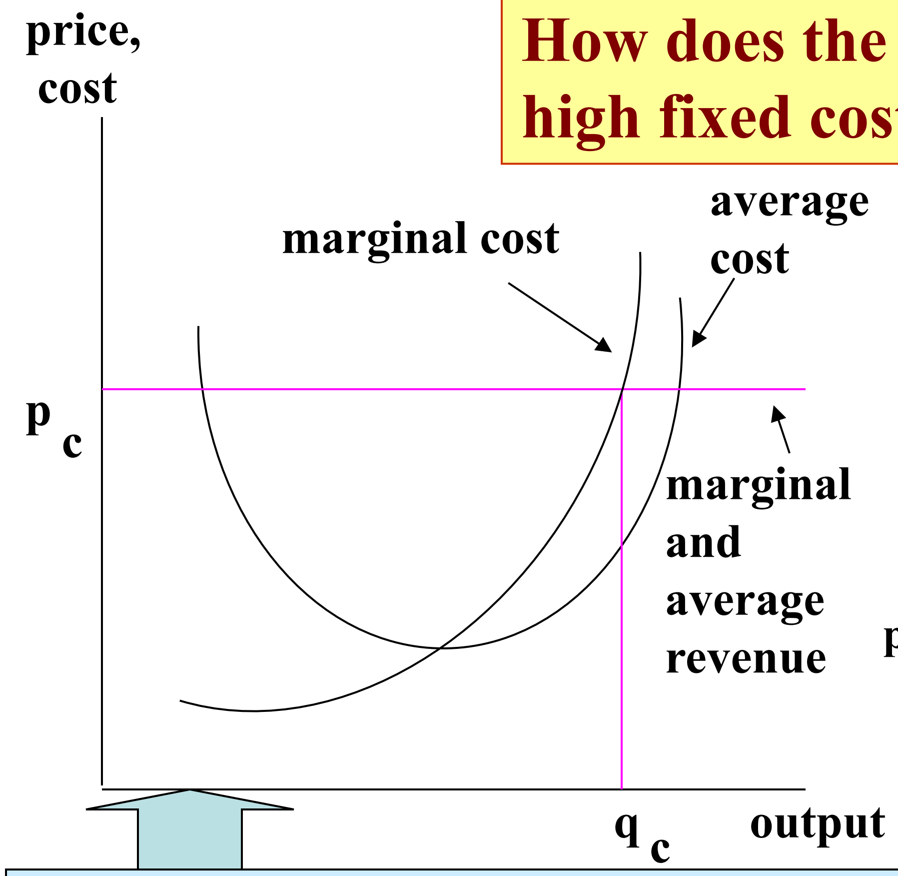
Reject the neoclassical obsession with free entry and market equilibrium

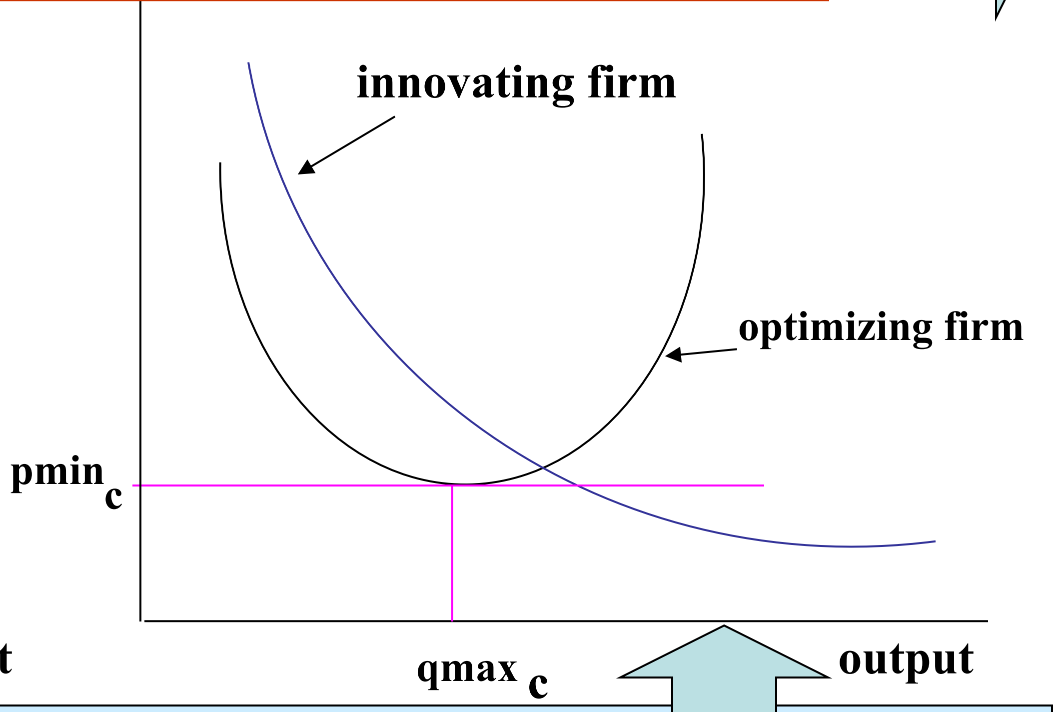


Comparing optimizing and innovating firms

p = price; q = output; c = perfect competitor
pmin = minimum breakeven price; qmax = maximum breakeven output

How does the innovating firm transform high fixed costs into low unit costs?





Technological and market conditions are given by cost and revenue functions.
The "good manager" optimizes subject to technological and market constraints.

Through strategy, organization, & finance, innovating firm transforms technologies and markets to generate higher quality, lower cost products. There is no "optimal" output or "optimal" price.

From high fixed costs to low unit cost

Transforming the theory of the optimizing firm into a theory of the innovating firm…

Strategy: confronting uncertainty, the innovating firm incurs *high-fixed costs* to develop a *higher-quality product* that, by gaining market share, is produced at low-unit cost

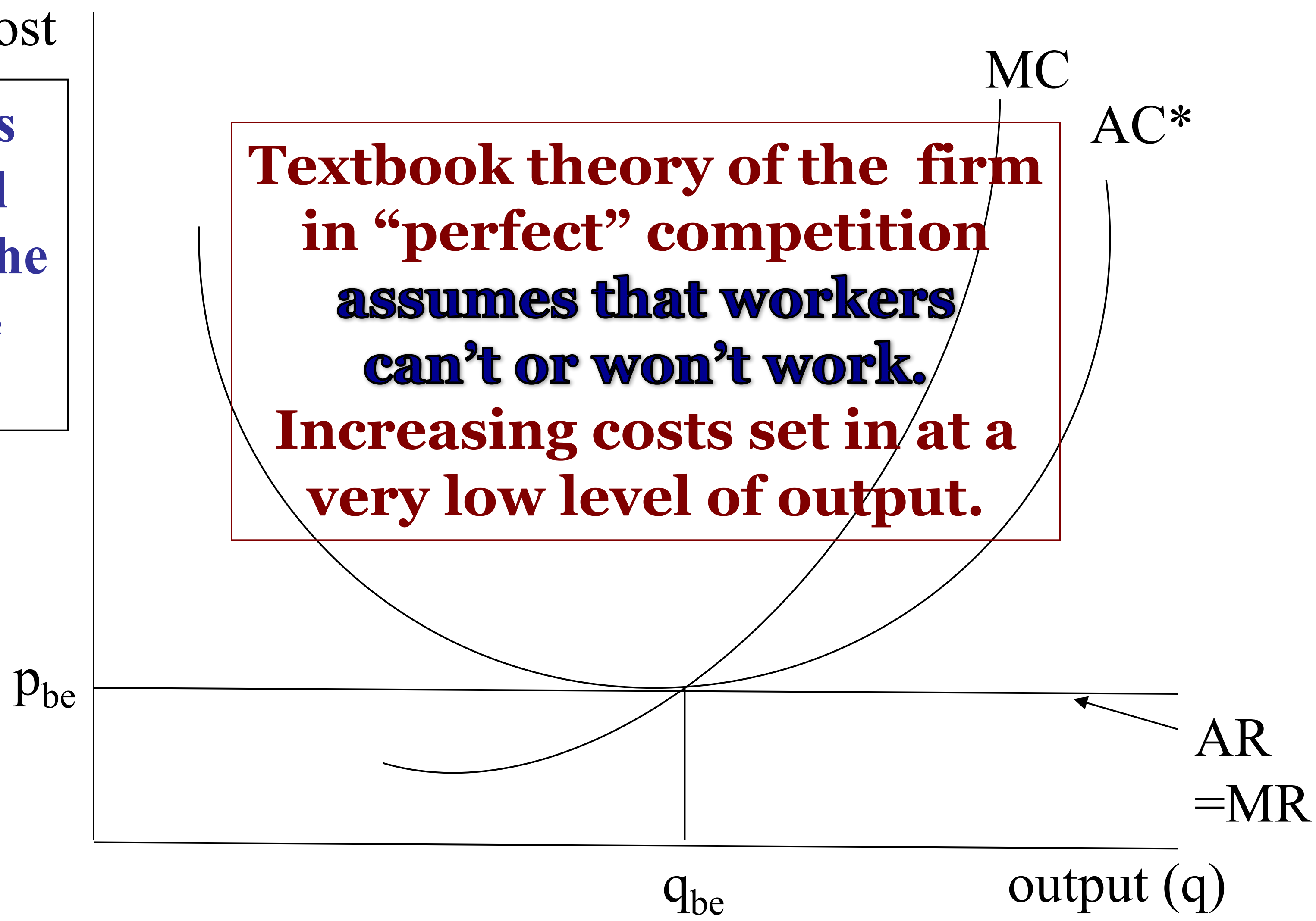
Organization: developing a higher-quality product and accessing a large market share require *collective and cumulative* (i.e., organizational) *learning*

Finance: it takes time to develop a higher-quality product and gain access to a large market share—the innovating firm *needs committed ("patient") capital* so that it does not have to drop out of the industry when unit cost exceeds product price

Neoclassical economics: the unproductive firm as the ideal of economic efficiency

The firm is very small relative to the size of the market.

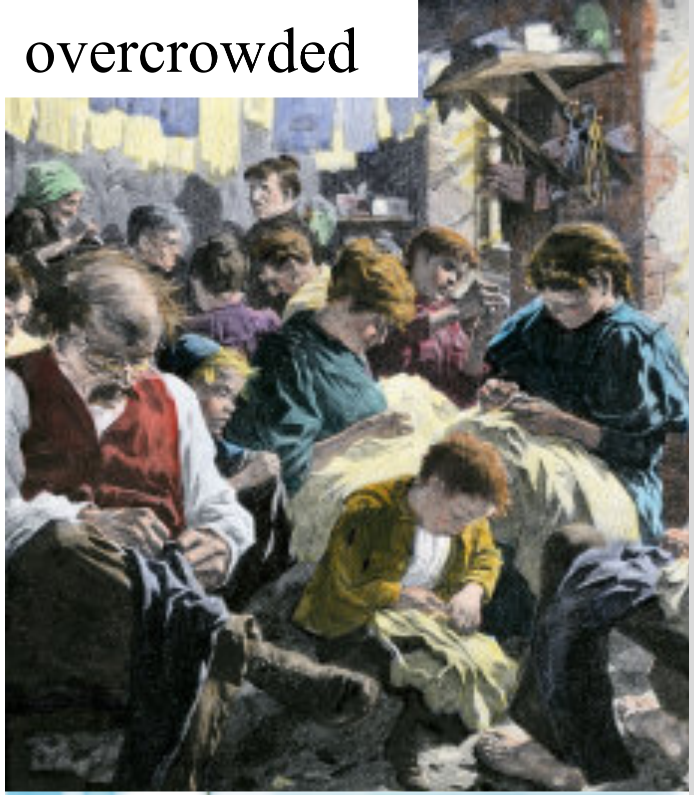
Free entry competes away profits.



Textbook theory of the firm in "perfect" competition assumes that workers can't or won't work. Increasing costs set in at a very low level of output.

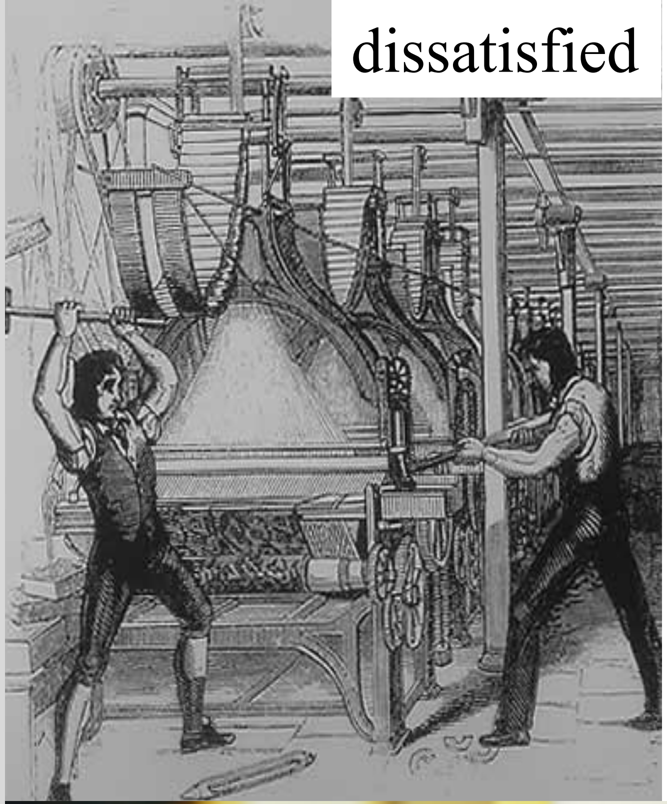
* AC = average total cost = average fixed cost + average variable cost

overcrowded

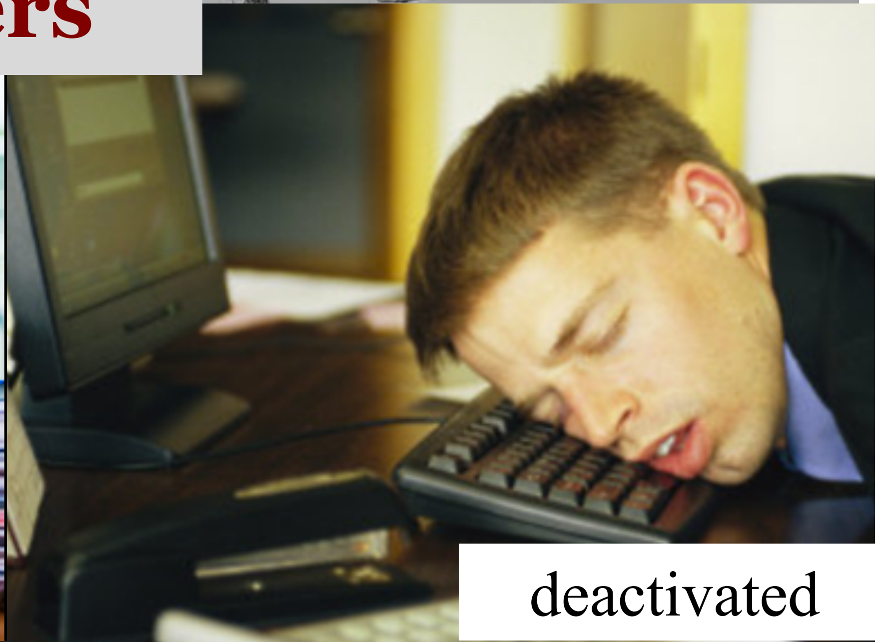


Foundations of “perfect” competition, and hence neoclassical economics = Low or no productivity workers

dissatisfied



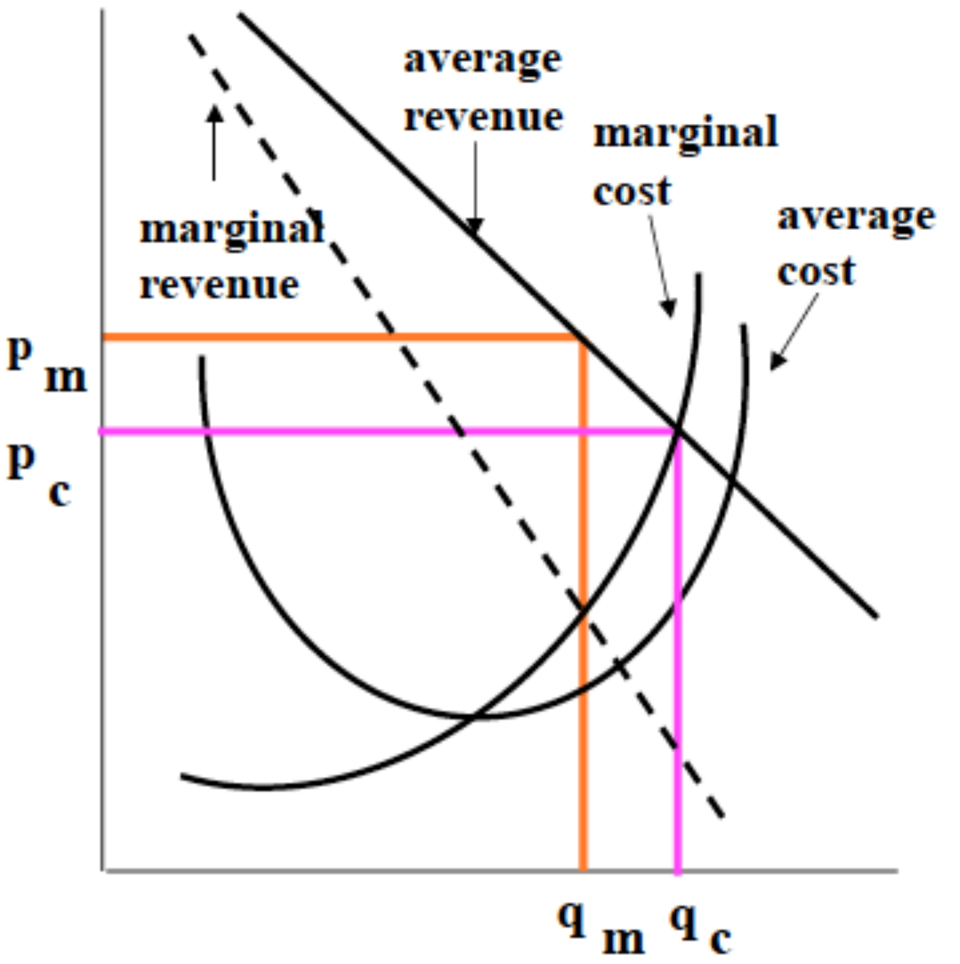
unmotivated



deactivated

Proof that “perfect competition” is superior?

p = price; q = output
m = monopolist; c = perfect competitor

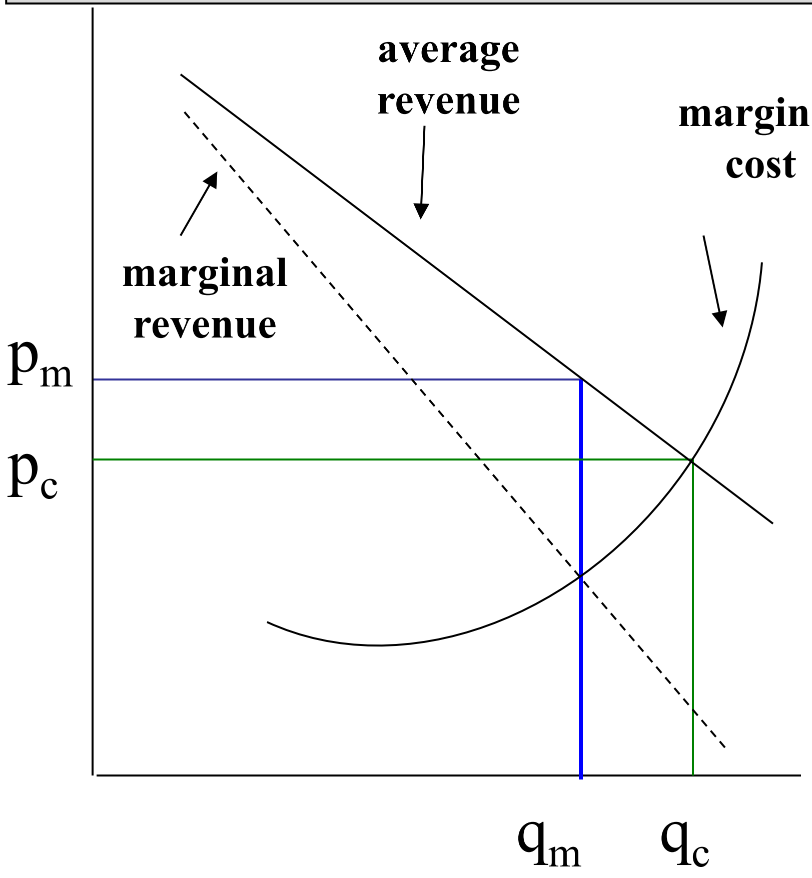


The theory of monopoly supposedly proves the superiority of “perfect” competition by showing that monopoly results in higher prices and lower output than perfect competition.

But how did the monopolist gain a dominant market position? It is ILLOGICAL to assume that the cost structures of firms in “perfect” competition are the same as that of a firm that dominates the industry.

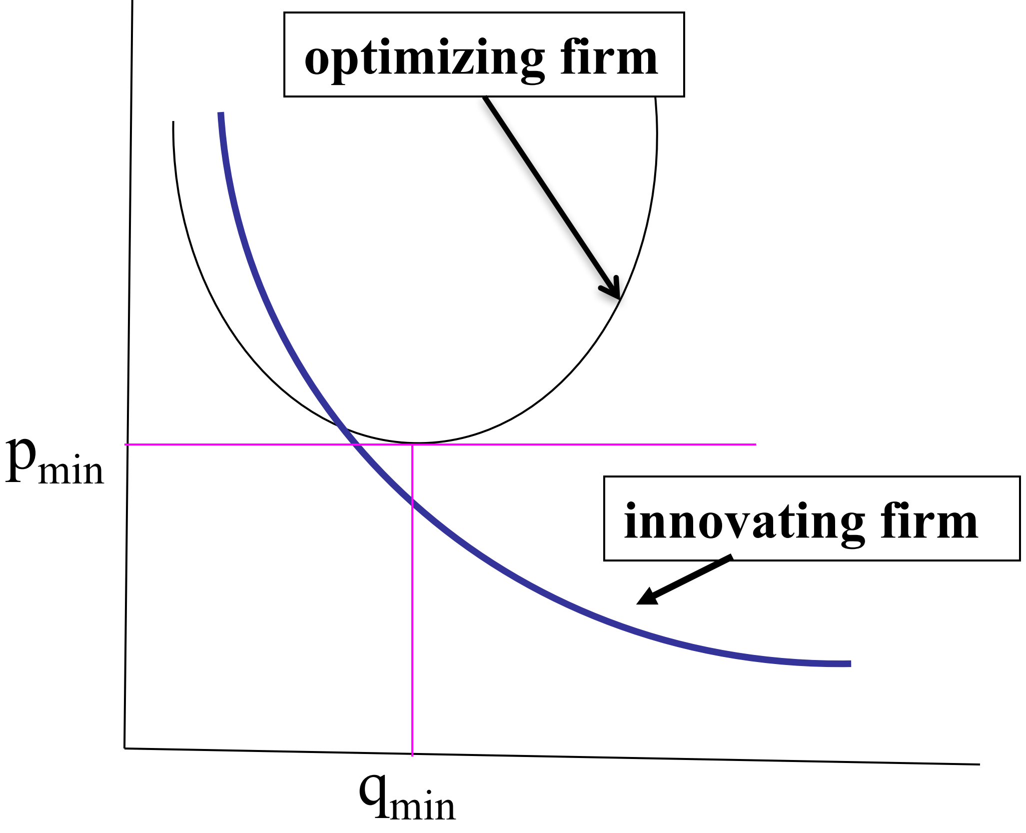
The innovating firm transforms technological and market conditions that the optimizing firm accepts as "given" technological and market constraints.

Monopoly and competition: ILLOGICALCOMPARISON



p_m = monopoly price; q_m = monopoly output
P_c = competitive price; q_c = competitive output

Innovating and optimizing firms LOGICAL COMPARISON



p_{min} = lowest breakeven price, optimizing firm
q_{min} = lowest breakeven output, optimizing firm

Economics needs a theory of innovative enterprise

By creating new sources of value embodied in higher-quality, lower-cost products, the innovative enterprise makes it possible (but by no means inevitable) that, simultaneously, *all participants in the economy can gain*:

- **Employees:** Higher pay, better work conditions
- **Creditors:** More secure paper
- **Shareholders:** Higher dividends or share prices
- **Government:** Higher taxes
- **The Firm:** Stronger balance sheet

AND

- **Consumers:** Higher quality, lower cost products

Foundations of economic analysis: Social conditions of innovative enterprise

- **Strategic control**: a set of relations that gives decision-makers the power to allocate the firm’s resources to confront uncertainty by transforming technologies and markets to generate higher quality, lower cost products

- **Organizational integration**: a set of relations that create incentives for people to apply their skills and efforts to engage in collective learning

- **Financial commitment**: a set of relations that secure the allocation of financial resources to sustain the cumulative innovation process until it generates financial returns

How MSV undermines innovation

Maximizing Shareholder Value (MSV) is an ideology that is destructive of innovative enterprise

- **Strategic control:** MSV permits separation of interests of top executives from interests of the corporation; executives use MSV to justify resource allocation (e.g., buybacks) for their personal gain
- **Organizational integration:** MSV undermines workers' incentives and abilities to engage in collective and cumulative learning (the essence of the innovation process) – MSV favors "downsize" (layoffs, wage cuts, offshoring)
- **Financial commitment:** MSV drains the company of financial resources needed to sustain innovation—in the name of MSV, top executives and activist shareholders make tens or hundreds of millions of dollars as *predatory value extractors* – MSV favors "distribute" (buybacks & dividends)

Why we need a theory of innovative enterprise

- Every year PhD economists teach millions of students around the world that **the unproductive firm is the foundation of the most efficient economy.** (If that sounds absurd, it's called neoclassical economics.)
- Neoclassical economists have a **trained incapacity** to understand how firms operate and perform.
- The theory of the unproductive firm as the foundation of the most efficient economy makes **the firm impotent** and **the market omnipotent** in the allocation of the economy's resources.
- This absurd view of the economic world underpins agency theory and its shareholder-value ideology, **which is actually destroying the U.S. economy (and others).**

What can academics do?

- **Debunk** the absurd body of “knowless” called neoclassical economics—e.g., show that its foundation is a theory of the unproductive firm
- **Build** a rigorous and relevant economic perspective based on the theory of innovative enterprise (supported by the developmental state)
- **Train** academics to integrate theory and history (i.e., use logic to explore rather than ignore facts, and use facts to build logic)
- **Attack** the ideology, built on the neoclassical theory of the market economy, that companies should be run to “maximize shareholder value”

Most of my recent writing on innovative enterprise and sustainable prosperity can be found on the website of the Institute for New Economic Thinking: https://www.ineteconomics.org/research/experts/wlazonick