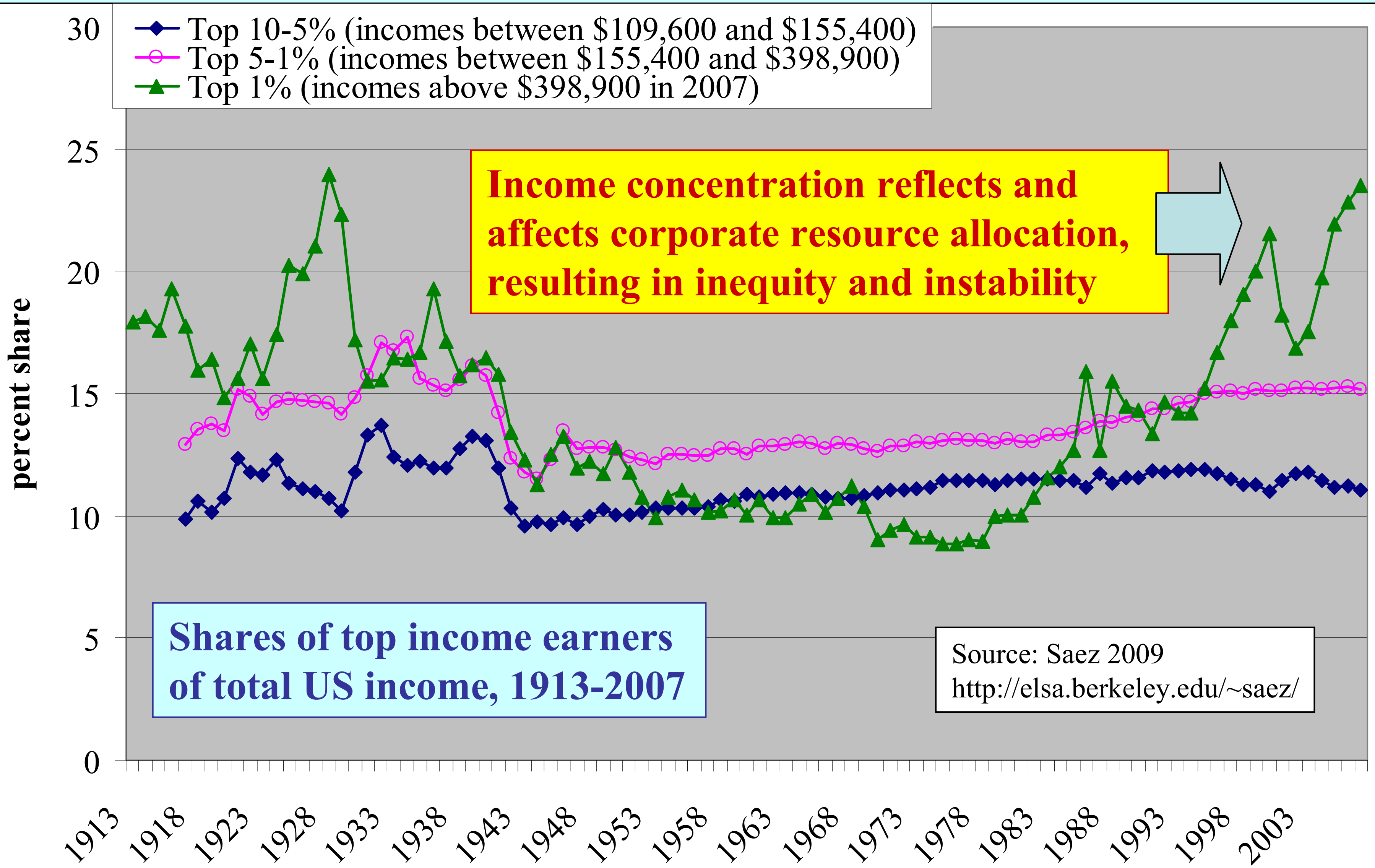
Why Executive Pay Matters to Innovation and Inequality

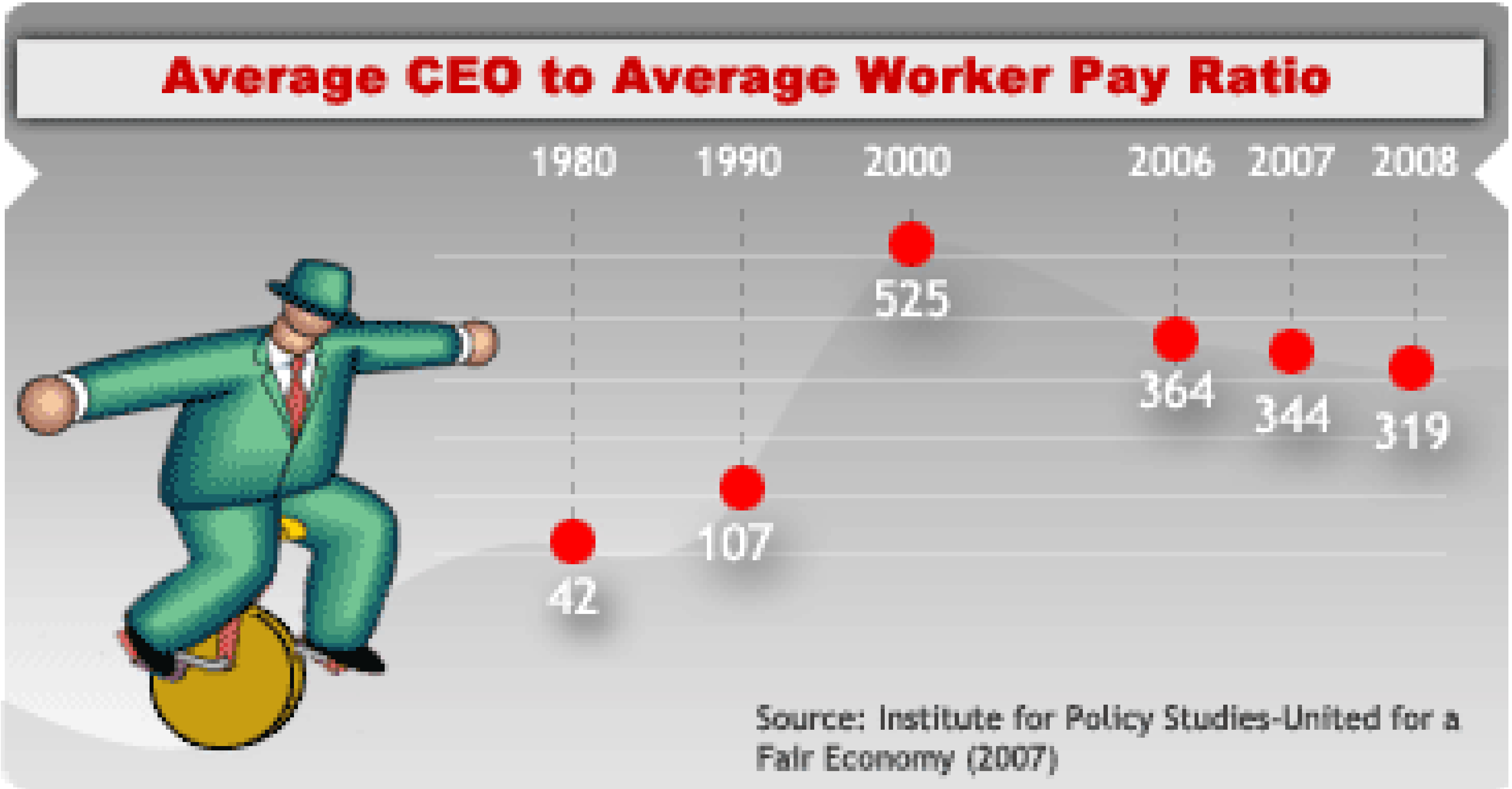
William Lazonick
University of Bordeaux

Workshop on Innovation and Inequality
Sant'Anna School of Advanced Studies
May 15, 2010

Why executive pay matters:
It reflects and affects corporate resource allocation



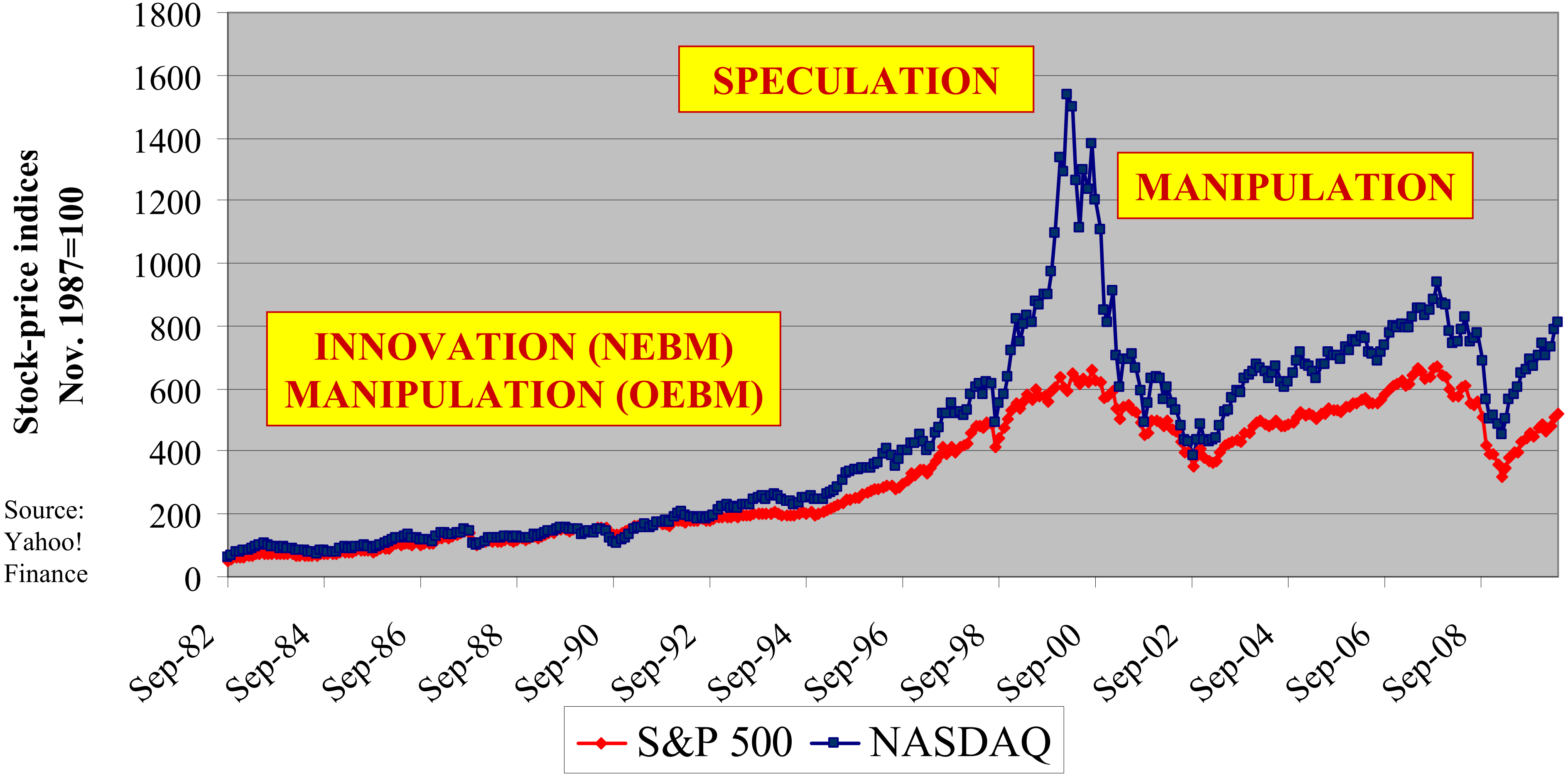
From AFL-CIO Executive Paywatch



http://www.aflcio.org/corporatewatch/paywatch/

Drivers of the stock market: Innovation, speculation, manipulation

Stock-price movements September 1982-April 2010



Source: Yahoo! Finance

See Lazonick, Sustainable Prosperity in the New Economy?, Upjohn Institute, 2009.

Stock-market fueled executive pay:
500 highest paid US corporate executives, 1992-2008

	Mean pay 2008$m	% from options	NASDAQ Index	S&P 500 Index
1992	9.2	59	604	417
1993	9.0	51	720	453
1994	8.0	45	754	461
1995	9.6	48	935	547
1996	13.7	54	1178	675
1997	18.3	61	1470	876
1998	26.9	65	1812	1088
1999	27.5	71	2788	1331
2000	40.4	80	3710	1420
2001	23.7	66	2006	1186
2002	16.8	49	1520	989
2003	21.0	55	1659	968
2004	24.6	62	1993	1134
2005	28.2	63	2101	1208
2006	29.0	58	2797	1318
2007	27.4	58	2588	1478
2008	16.6	48	2149	1215

Gains from speculation

Gains from manipulation

From
William Lazonick
The Explosion of
Executive Pay
and
the Erosion of
American Prosperity

Source: Compustat

Speculative gains in the 1980s and 1990s

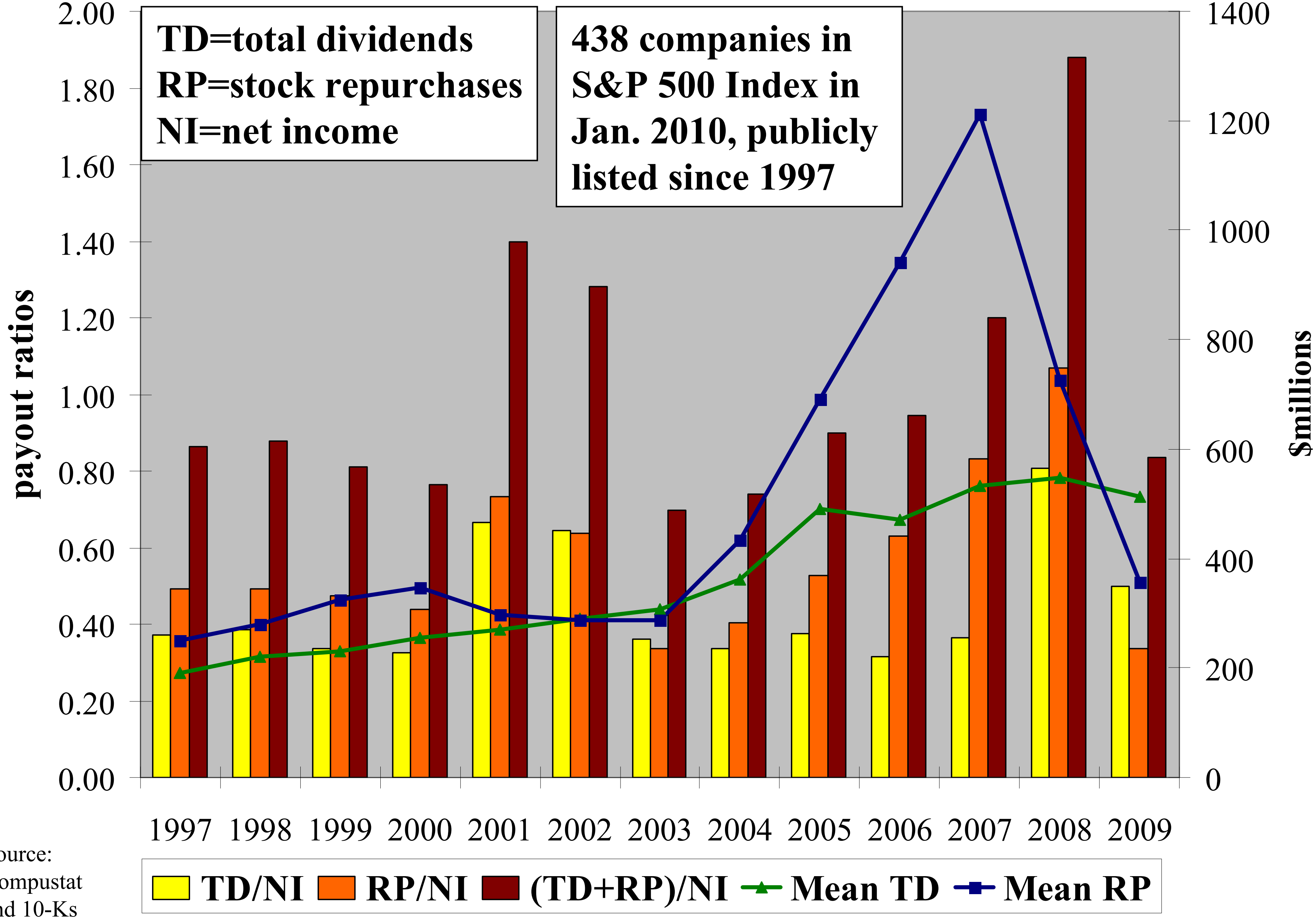
Average Annual US Corporate Stock and Bond Yields (percent), 1960-2009

	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009
REAL STOCK YIELD	**6.63**	**-1.66**	**11.67**	**15.01**	**-3.08**
PRICE YIELD	5.80	1.35	12.91	15.54	-2.30
Dividend yield	3.19	4.08	4.32	2.47	1.79
Change in CPI	2.36	7.09	5.55	3.00	2.57
REAL BOND YIELD	**2.65**	**1.14**	**5.79**	**4.72**	**3.41**

With unindexed stock options and double-digit annual stock price yields in the longest bull-run in US stock market history, the explosion of executive pay was automatic in the 1980s and 1990s.

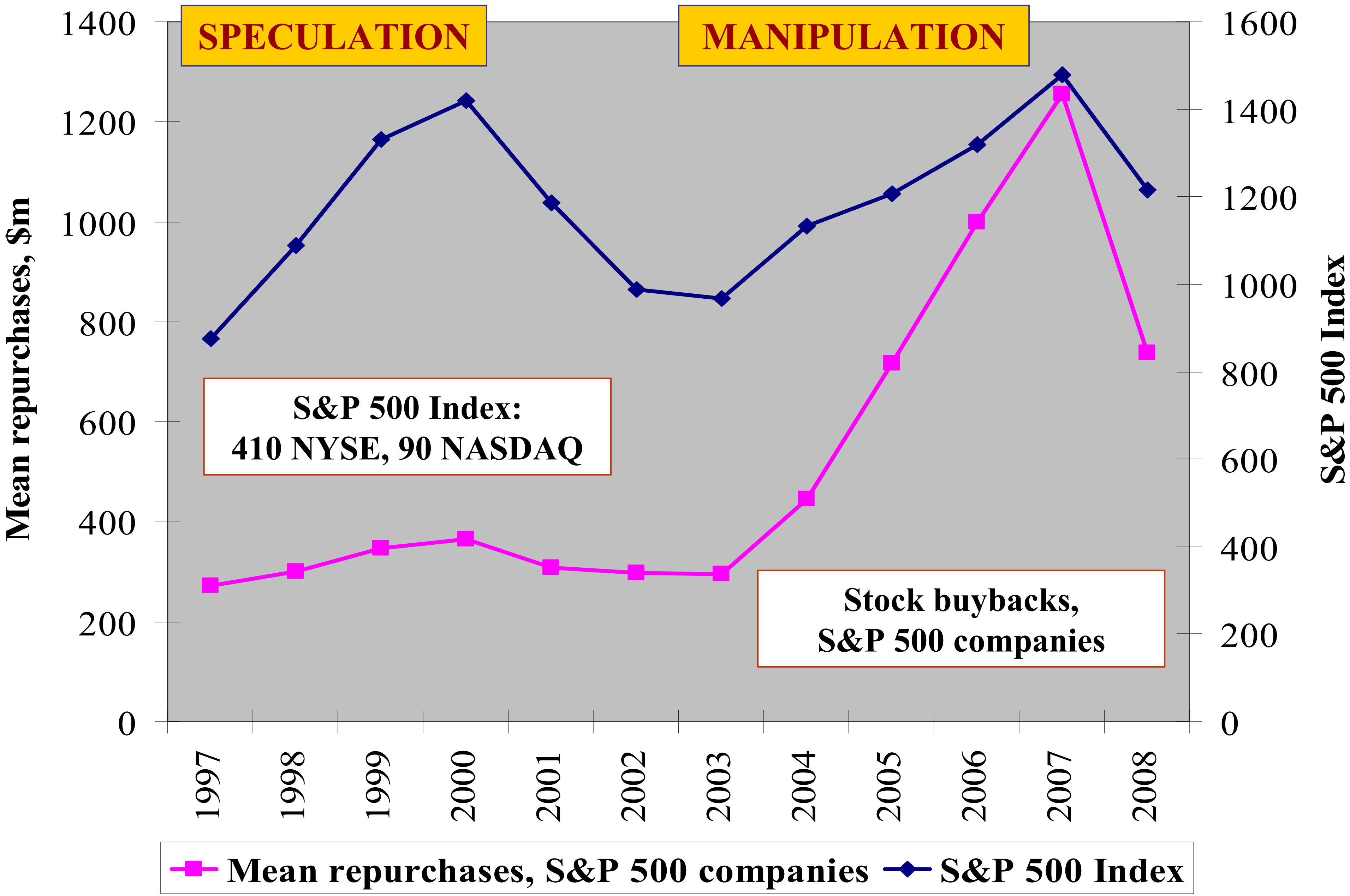
Source: Economic Report of the President 2009

Stock buybacks, 1997-2009



Source: Compustat and 10-Ks

Manipulating the stock market in the 2000s



SEC Rule 10b-18 (1982)

1982: SEC clarified conditions under which corporate stock buybacks would enjoy a "safe harbor" from charge of stock market manipulation under Securities Exchange Act of 1934

SEC Rule 10b-18: according to a news report, "made it easier for companies to buy back their shares on the open market without fear of stock-manipulation charges" (Hudson 1982)

SEC Chairman John Shad was an advocate of the rule change, arguing that large-scale open market purchases would fuel an increase in stock prices that would be beneficial to shareholders.

One SEC Commissioner argued that Rule 10b-18 would leave some manipulation unprosecuted, but made SEC vote unanimous

1982 was the beginning of the 18-year upward movement in stock prices that is generally described as the longest "bull run" in US stock market history

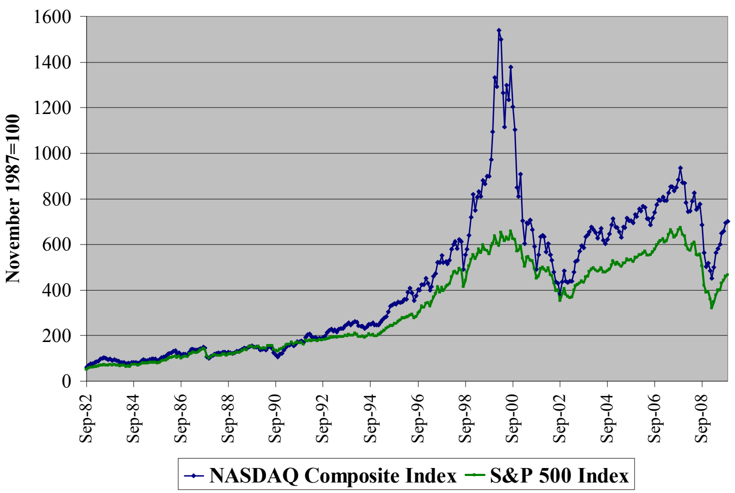
SEC Rule 10b-18:
Mandate for Managers to Manipulate the Market

SEC Eases Way For Repurchase Of Firms' Stock

Agency Assures It Won't File Charges of Manipulation If Certain Rules Are Met

By RICHARD L. HUDSON
Staff Reporter of THE WALL STREET JOURNAL

Wall Street Journal, Nov. 10,1982



Arguing for the rule change, SEC Chairman John Shad said stock repurchases "confer a material benefit" on a company's shareholders, by fueling increases in market stock prices. Without the change, he said companies are "inhibited" from making big open-market buys.

Protest Voiced

The new, deregulation-minded commission, with its 3-2 majority of Reagan appointees, has been revamping many SEC policies.

But the easing in repurchase regulation elicited a sharp protest from one SEC commissioner, John Evans, first appointed to the panel in 1973. The change means "there will be some manipulation" that will go unprosecuted, he complained at yesterday's meeting. "This is much-reduced regulation from what we had before," he said.

Nevertheless, when it became apparent that he was being outvoted, he cast his vote "with some concern" in favor of the change, making it a unanimous action. SEC commissioners rarely cast dissenting votes, preferring to project a public image of unanimity.

“SEC’s Shad Pledges ‘Bulk’ of $30 Million For Ethics Program --- Harvard Business School Calls Gift by the ‘49 Graduate Its Largest on Record”

Wall Street Journal, Mar. 31, 1987

When profits are made, how are they spent?

William Lazonick

BusinessWeek **Outside Shot** August 13, 2009, 5:00PM EST

The Buyback Boondoggle

Companies spend lavishly on share repurchases, slowing innovation and job creation

As the unemployment rate hovers near 10%, the economic debate is focused on how the government should aid recovery. (More stimulus spending? Tax cuts?) But it's business' task to get the economy back on track—by investing in innovation and job creation. And if the recent past is any guide, corporations may stall the recovery by investing instead in something else: stock buybacks.

America urgently needs a debate on stock buybacks. There is no sound economic rationale for these investments. Justified by the notion of maximizing shareholder value, they do nothing for the economy—and a lot for CEOs receiving stock-based compensation.

The amount of money spent on buybacks is staggering. From 1997 through last year, 438 companies in the Standard & Poor's 500-stock index spent $2.4 trillion on them. In 2007, as profits soared, the average buyback bill for each was about $1.2 billion—a record amount. And faced with a dramatic drop in their combined net income in 2008, these companies trimmed buyback spending, but not proportionately: The buyback-to-profit ratio, which was already unprecedented in 2007, more than tripled in 2008, from 0.90 to 2.80.

RP Rank 2000-2008	Company	*Fortune* rank, 2008	RP ($m) 2007	RP ($m) 2008	RP ($m) 2000-2008
1	EXXON MOBIL	1	31,822	35,734	144,038
2	**MICROSOFT**	35	27,575	12,533	94,280
3	**IBM**	14	18,828	10,563	72,881
4	*BANK OF AMERICA*	11	3,790	0	55,674
5	**CISCO SYSTEMS**	57	7,681	10,441	53,570
6	*GENERAL ELECTRIC*	5	14,913	3,222	51,771
7	PFIZER	46	9,994	500	50,632
8	**INTEL**	61	2,788	7,195	48,770
9	PROCTER & GAMBLE	20	5,578	10,047	46,371
10	**HEWLETT-PACKARD**	9	10,887	9,620	43,341
11	*CITIGROUP*	12	663	7	37,148
12	JOHNSON & JOHNSON	29	5,607	6,651	33,345
13	*GOLDMAN SACHS*	40	8,956	2,034	32,220
14	**DELL**	33	3,026	4,004	29,549
15	**AT&T**	8	10,390	6,077	27,705
16	WAL-MART STORES	2	1,718	7,691	27,324
17	HOME DEPOT	25	6,684	10,815	27,203
18	CHEVRON	3	7,036	8,011	26,868
19	**ORACLE**	113	3,937	2,023	25,962
20	TIME WARNER	48	6,231	332	25,497

Buyback leaders 2000-2008 1-20

Financial services

ICT

Pharma

Oil refining

Health

RP Rank 2000-2008	Company	*Fortune* rank, 2008	RP ($m) 2007	RP ($m) 2008	RP ($m) 2000-2008
21	PEPSICO	52	4,312	4,726	25,430
22	*WELLS FARGO*	41	7.418	1,623	24,866
23	UNITEDHEALTH GROUP	21	6,599	2,684	23,362
24	AMGEN	168	5,100	2,268	22,629
25	WALT DISNEY	60	6,923	4,453	22,268
26	*JPMORGAN CHASE*	16	8,178	0	21,248
27	*MERRILL LYNCH*	150	5,272	0	21,028
28	UPS	43	2,639	3,570	20,944
29	*MORGAN STANLEY*	30	3,753	711	19,761
30	ALTRIA GROUP	160	0	1,166	19,379
31	MERCK	103	1,430	2,725	18,709
32	**TEXAS INSTRUMENTS**	215	4,886	2,122	18,418
33	CONOCOPHILLIPS	4	7,001	8,249	18,099
34	*AMERICAN EXPRESS*	74	3,572	218	17,861
35	MCDONALD'S	107	3,943	3,919	16,797
36	CBS	186	3,351	46	16,565
37	BOEING	34	2,775	2,937	15,813
38	3M	95	3,239	1,631	15,152
39	WELLPOINT	32	6,151	3,276	14,867
40	*ALLSTATE*	81	3,606	1,323	13,657

Buyback leaders 2000-2008 21-40

Financial services

ICT

Pharma

Oil refining

Health

RP Rank 2000-2008	Company	*Fortune* rank, 2008	RP ($m) 2007	RP ($m) 2008	RP ($m) 2000-2008
41	*PRUDENTIAL FINANCIAL*	84	3,000	2,161	13,050
42	*U. S. BANCORP*	129	1,983	0	12,313
43	**COMCAST**	68	3,102	2,800	12,289
44	UNITED TECHNOLOGIES	37	2,001	3,160	11,902
45	COCA-COLA	73	1,838	1,079	11,668
46	KIMBERLY-CLARK	128	2,813	653	10,655
47	CATERPILLAR	44	2,405	1,800	10,496
48	CARDINAL HEALTH	18	3,662	1,182	10,315
49	**APPLIED MATERIALS**	315	1,332	1,500	10,241
50	VALERO ENERGY	10	5,788	955	9,991

Buyback leaders 2000-2008 41-50

Sources: Compustat and company 10-K filings

Among the top 50:

- **12 in financial services**
- **11 in ICT**
- **4 in pharmaceuticals**
- **4 in petroleum refining**
- **3 in health insurance and health care**

Top 50 for 2000-2007 included Wachovia and Washington Mutual

Why do companies repurchase stock?

- **Executives say that they are showing confidence in their company's future performance – but their companies only sell stock to the public when compelled to do when so in financial distress**
- **If the company were to sell its stock when its price was high, its executives would be announcing to the financial world that they no longer have confidence in the company's stock! So they almost never do it.**
- **At the same time, these very same executives have no problem selling their own stock (much of it acquired by exercising stock options) when the price is high – resulting in the explosion in executive pay**

What's wrong with buybacks

- **Wall Street banks did buybacks even as they were betting the company (and the economy) on derivative speculation, and ended up going to foreigners and the US government to bail them out**

  Eight of the biggest bailed-out banks spent a total of $182 billion on buybacks from 2000 to 2007

- **Leading ICT companies do huge buybacks with the profits from offshoring even as they lay off US workers, and even as they demand that the government invest more in the high-tech knowledge base to make "America" competitive – e.g., in 2005 alone the $10.6b. that Intel spent on buybacks exceeded the total budget of the National Nanotechnology Initiative for 2001-2009**

What's wrong with buybacks

- Oil companies do massive buybacks, while Americans pay high fuel prices and lack adequate investment in alternative energy – from 2000-2009 Exxon Mobil repurchased $163.7b., including $31.8b. in 2007, $35.7b. in 2007, and, $19.7b. in 2009

- Leading pharmaceutical companies keep US drug prices at least double the prices in other advanced countries – they argue in Congress that high US drug prices are needed to fund drug research – yet many do buybacks equal to 50-100% of R&D expenditures

What’s wrong with buybacks

- **Health care insurers and providers** do huge buybacks even as the nation’s health care system is in crisis – buybacks/net income, 2000-2008: United Health 104%, Wellpoint 104%, Aetna 137%, Cigna 125%

- **Wal-Mart** does multi-billion $ buybacks while the wages of its 2 million “associates” yield a low standard of living

- If **General Motors** had banked the $20.4b. distributed to shareholders as buybacks from 1986 through 2002 (with a 2.5% after-tax annual return) it would have had **$35b. of its own cash** to help keep it afloat and respond to global competition when it went bankrupt

“Weapons of value destruction”

Stock buybacks in ICT: 2000-2008

Microsoft: $94b. IBM: $73b. Cisco: $54b.

Intel: $49b. HP: $43b. Dell: $32b.

Oracle: $26.0b. TI: $18.4b. Applied Materials: $10.2b.

And buybacks continued in 2009…

- **IBM:** first half of 2009, lays off 10,000 workers in N. America; 2009: expended $7.4b. on buybacks and $2.9b. on dividends, out of income of $13.4b.
- **HP:** 2009 mass “integration” layoffs; 2009 buybacks $5.1b., plus $2.3b. Q1-2010
  Intel: Jan. 2009, announces 5,000-6,000 layoffs; July 2009, does $1.75b. convertible debt issue, of which $1.5b.for buybacks ($1.67b.)
- **Microsoft:** FY2009, buybacks $9.4b., layoffs 5,000;, targeting 5,000; May 2009 $3.75b. bond issue (first l-t debt offering) for buybacks (did $5.4b.,Q1-Q2, 2010)
- **Oracle:** July 2009, 1,000 layoffs in Europe despite strong growth; buybacks $4.0b. year ending May 31, 2009 ($730m. first half FY2010)
- **Unemployment rate in Silicon Valley currently almost 12%**

Intel touts its buybacks

http://www.intc.com/stockBuyBack.cfm

From Intel's website: "Buybacks occur when a company purchases shares of its own publicly traded stock in the open market. We have an ongoing authorization, amended in November 2005, from our Board of Directors to repurchase up to $25 billion in shares of our common stock in open market or negotiated transactions. "

Quarter	Shares Purchased (m.)	Cum. Shares Purchased (m.)	$Millions	Cum. $ Millions
2009 Buybacks				
Q4	0.0	3,351.1	0.0	68,553.5
Q3	88.42	3,351.1	1,670.8	68,553.5
Q2	0.0	3,266.9	0.0	66,882.7
Q1	0.0	3,266.9	0.0	66,882.7
2008 Buybacks				
Q4	0.0	3,266.9	0.0	66,882.7
Q3	93.4	3,266.9	2,117.0	66,882.7
Q2	108.8	3,173.5	2,500.0	64,765.7
Q1	121.9	3,064.7	2,500.0	62,265.7

maximizing shareholder value

Quarter	Shares Purchased (m.)	Cum. Shares Purchased (m.)	$Millions	Cum. $ Millions
1990 Buybacks				
Q4	10.0	102.8	11.0	102.4
Q3	92.8	92.8	91.4	91.4

Intel and nanotechnology

ICT industry in general and Intel in particular have benefited from decades of government investment in the high-tech knowledge base

Intel and Semiconductor Industry Association (SIA) lobby Congress for more spending on the National Nanotechnology Initiative (NNI)

At SIA press conference in DC in March 2005, Intel CEO Craig Barrett warned:

"U.S. leadership in the nanoelectronics era is not guaranteed. 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."

In 2005 annual NNI budget was $1.2b., just 11% of $10.6b. that Intel spent on buybacks in 2005: exceeded total of $10.1b. spent on NNI since its inception in 2001 through 2009 (Intel's buybacks, 2001-2009=$44.8b.)

Intel and its industry should be allocating substantial resources to national technology programs "to ensure that America continues to be the world leader in information technology"

The biggest pharma repurchasers

Pharmaceutical companies argue to Congress that they need high drug prices in US to fund R&D

But some of them spend a large proportion of their profits on stock repurchases (RP) (NI=net income; TD=total dividends)

Source: Compustat	2008		1997-2008			
	Rev. $b.	F500 rank	RP/ NI	(TD+RP)/ NI	RP/ R&D	(TD+RP)/ R&D
J&J	63.7	29	0.40	0.79	0.60	1.17
Pfizer	48.3	46	0.73	1.41	0.73	1.42
Abbott	29.5	80	0.18	0.71	0.27	1.04
Merck	23.9	103	0.41	0.93	0.72	1.63
Wyeth	22.8	110	0.15	0.67	0.16	0.71
BMS	20.6	120	0.23	0.91	0.26	1.03
Eli Lilly	20.4	122	0.29	1.03	0.22	0.77
Schering-Plough	18.5	138	0.13	0.75	0.08	0.45
Allergan	4.4	517	0.68	0.93	0.32	0.43

The biggest dedicated biopharma repurchasers

Some of the leading dedicated biopharmaceutical companies are big repurchasers of their own stock:

Source: Compustat	2008		1997-2008			
	Rev. $b.	F500 rank	RP/ NI	(TD+RP)/ NI	RP/ R&D	(TD+RP)/ R&D
Amgen	15.0	168	1.15	1.15	0.97	0.97
Genentech	13.4	201*	0.72	0.72	0.63	0.63
Gilead Sciences	5.3	444	0.84	0.84	0.50	0.50
Genzyme	4.6	502	0.18	0.18	0.06	0.06
Biogen Idec	4.1	546	2.63	2.63	0.86	0.86

* Rank if Genentech had been included in the 2009 Fortune 500

Amgen, 1997-2009: RP=$18.2b.; RP/NI=1.07; RP/R&D=0.99

… and boosting stock prices boosts executive pay

Gains from exercise of stock options, *average* for CEO and other four highest paid executives, selected companies, 1997-2008 ($millions)

	AMGEN	GENENTECH	J&J	MERCK	PFIZER
1997	3.0	0.0	3.6	2.9	5.8
1998	11.3	0.6	2.3	0.5	8.7
1999	13.3	10.8	10.4	3.4	13.7
2000	42.1	23.4	1.7	12.6	8.8
2001	4.3	0.4	1.5	0.4	5.9
2002	3.0	0.0	3.1	0.9	0.0
2003	2.8	14. 3	2.5	2.3	0.3
2004	1.7	24.2	0.6	8.3	0.0
2005	9.4	31.1	1.0	0.8	1.3
2006	1.0	4.4	1.6	0.2	1.7
2007	0.1	5.9	0.9	0.0	0.3
2008	1.2	na	0.9	0.0	0.0
1997-2008	$93.2	$115.1	$30.0	$32.4	$46.6

Amgen's $5 billion stock repurchase, May 2007

Amgen 10-Q, filed August 9, 2007, for period ending June 30, 2007:

"In May 2007, we issued $2.0 billion aggregate principal amount of floating rate notes due in 2008…, $1.1 billion aggregate principal amount of notes due in 2017…and $0.9 billion aggregate principal amount of notes due in 2037…in a private placement. A total of $3.2 billion of the net proceeds raised from the issuance of these notes were used to repurchase shares of our common stock under a block trade entered into in May 2007."

In May 2007 Amgen repurchased $5b. of its own stock, adding $1.8b. in cash to add the $3.2b. it borrowed for the purpose

The view from Wall Street

On August 13, just after Amgen issued its second quarter 10-Q filing that recorded a sales decline, an analyst at Bernstein Research wrote:

"Amgen will likely lose at least 40 percent of their US Aranesp revenue by 2008 with even greater downside possible for both Aranesp and Epogen if upcoming [Medicare and Medicaid] reimbursement and regulatory decisions go against them."
But the analyst reportedly added:

"If Amgen cuts costs, continues to buy back stock and improves its tax rate…it could increase its earnings per share by 10-12% each year from 2008 to 2011, even if it does not develop any significant drug candidates."

["Amgen moves up after analyst says company will restructure to increase earnings," Associated Press Financial Wire, August 13]

Amgen responds

<u>Wall Street Journal</u>, August 17, 2007: "Amgen Cuts Mark Biotech Squeeze": Regulatory Pressures Push Firm to Slash Jobs, Costs; More Challenges Ahead?"

"Amgen Inc. said it will cut staff by up to 14% [2,600 jobs], slash capital expenses by $1.9 billion, and close some production facilities in an effort to offset falling sales of its top-selling anemia drug Aranesp."

"Sales of anemia drug Aranesp fell 19% in the second quarter after reports of heart attacks at high doses."

Kevin Sharer, Amgen CEO, "said the trigger for the restructuring was a very 'patient unfriendly' Medicare coverage decision capping the hemoglobin target -- a measure of the protein that carries oxygen in red blood cells -- for cancer chemo patients at 10 grams per deciliter. The FDA approved label targets of 10 to 12."

"Amid the massive cutbacks, Amgen said research and development spending will slow to 20% of sales, from past rates of 22% to 23%."

Opponents of health care reform

Log In | Sign Up

The Huffington Post

THE HUFFINGTON POST

March 22, 2010

William Lazonick

Posted: March 16, 2010 01:35 PM

BIO

Become a Fan

Alerts

Bloggers' Index

Insurance Executives: A Big Part of Our Health Care Problem

http://www.huffingtonpost.com/william-lazonick/insurance-executives-a-bi_b_501093.html

Savings from health care reform?
ban buybacks

	2008		2000-2008					
Source: Compustat	rev., $b.	F500 rank	TD, $b.	RP, $b.	TD/NI %	RP/NI %	(TD+RP)/ NI %	SO gains. $m.
UnitedHealth	81.2	21	0.2	23.4	1	104	105	636
Wellpoint	61.3	32	0.0	14.9	0	104	104	219
Aetna	31.0	77	0.3	9.7	4	137	141	242
Humana	28.9	85	0.0	0.4	0	12	12	88
Cigna	19.1	132	0.9	9.8	11	125	136	143
Health Net	15.4	165	0.0	1.3	0	79	79	67
Coventry	11.9	226	0.0	1.4	0	48	48	142

SO gains: gains from exercising stock options by top executives named in proxy statements

Among the leading health insurers, United Health, Wellpoint, Aetna, and Cigna spent more than 100 percent income in the 2000s on stock buybacks – to the immense benefit of their top executives

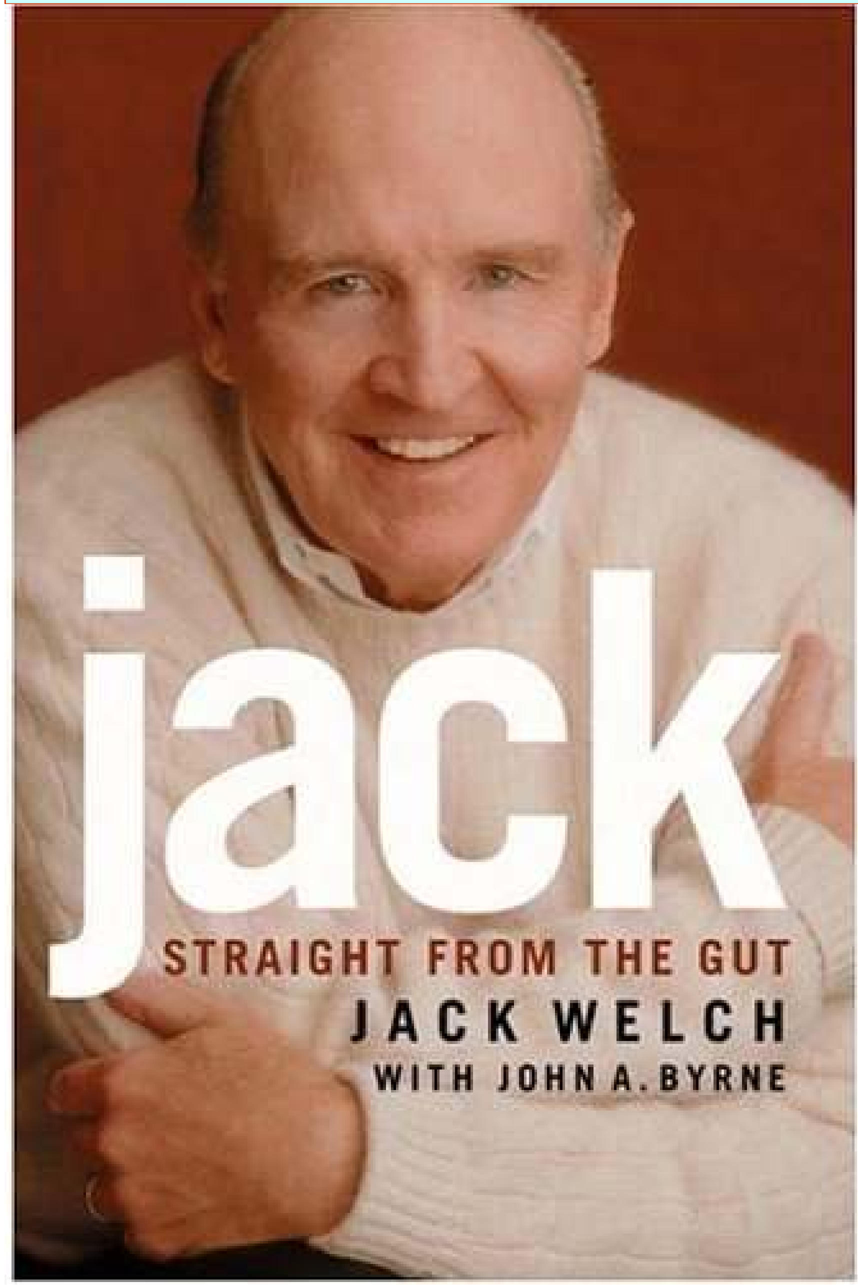
Exclude patients, raise premiums, do buybacks, get rich

Source: Compustat	2000	2001	2002	2003	2004	2005	2006	2007	2008
Over $10m. in red	**compensation, highest paid executive, $m.**								
UnitedHealth	55.8	58.1	1.3	94.2	124.8	13.6	127.0	12.9	9.5
Wellpoint	2.5	15.7	6.9	46.2	18.9	8.5	31.8	105.1	3.8
Aetna	12.7	3.5	8.9	18.2	22.2	35.3	46.7	40.2	7.3
Humana	2.7	1.6	1.6	6.1	2.5	3.3	28.8	20.1	2.4
Cigna	24.7	17.2	10.6	14.9	13.3	28.8	26.9	28.9	9.4
Health Net	1.0	0.8	6.1	14.2	2.6	11.6	12.0	13.2	2.6
Coventry	2.2	4.9	20.3	20.0	25.4	19.5	14.2	20.8	9.0
Over 33% in red	**% of total compensation from exercising stock options**								
UnitedHealth	83	87	0	89	92	89	98	83	66
Wellpoint	0	0	0	0	58	0	30	97	0
Aetna	0	0	0	42	82	77	82	82	0
Humana	0	1	0	6	3	23	90	83	29
Cigna	80	39	36	0	13	57	54	34	17
Health Net	0	0	86	71	0	85	92	90	26
Coventry	0	0	56	50	49	67	57	77	14

Exclude patients, raise premiums, do buybacks, get rich

Source: Compustat	2000	2001	2002	2003	2004	2005	2006	2007	2008
Over $5m. in red	mean compensation, five highest paid executives (top5), $m.								
UnitedHealth	14.8	17.8	6.2	32.2	42.1	6.4	27.2	6.5	4.4
Wellpoint	1.4	7.3	3.8	22.9	7.7	8.2	23.4	28.7	2.1
Aetna	5.8	1.9	4.9	9.8	6.6	18.8	21.6	15.6	3.2
Humana	2.0	1.2	1.0	3.6	1.6	2.4	10.3	9.2	1.2
Cigna	12.1	10.6	5.4	5.5	4.6	7.7	8.8	12.9	3.4
Health Net	0.8	0.6	2.3	3.2	1.2	18.6	7.8	6.0	1.2
Coventry	1.3	2.4	8.1	8.2	8.0	9.5	7.8	11.4	3.9
Over 33% in red	% of total comp. of top5 from exercising stock options								
UnitedHealth	77	83	51	88	91	38	91	59	35
Wellpoint	0	0	0	9	29	51	40	87	2
Aetna	0	0	4	36	69	78	63	75	0
Humana	0	0	3	10	2	39	84	80	22
Cigna	61	44	42	0	11	45	42	47	9
Health Net	0	0	47	62	0	64	62	59	12
Coventry	3	2	53	42	44	59	50	65	6

A recent critic of shareholder value ideology



The book was published in 2001

But it took Jack some eight years, and a massive financial meltdown, to get his most critical thoughts on corporate management out of his gut.

"It is a dumb idea"

In March 2009, John F. Welch, Jr., ex-CEO of GE told a Financial Times reporter:

"On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy…your main constituencies are your employees, your customers and your products."

He went on to reiterate: "It is a dumb idea. The idea that shareholder value is a strategy is insane. It is the product of your combined efforts – from the management to the employees."

Francesco Guerrera, "Welch rues short-term profit 'obsession'," Financial Times, March 12, 2009.

The "dumb idea" in theory

- **Agency theory** (e.g., Michael Jensen) provides the theoretical foundations of shareholder-value ideology: shareholders as residual claimants because they are the only contributors to the business enterprise who do not have a guaranteed return – shareholders bear risk: gain from profits, absorb losses
- Agency theory put forward as an attack on incumbent management and "managerial discretion" – its policy prescription: **"disgorge the free cash flow"** to shareholders so they can reallocate resources to better uses in the economy
- Agency theory has justified corporate raiders and takeovers, taking companies private, aligning incentives of top executives with shareholders through stock-based compensation, distributing the so-called "free cash flow" to shareholders through not only dividends but more importantly stock buybacks

Innovation theory versus agency theory

- Fundamental flaw in agency theory: government (taxpayers) and employees make investments in companies without contractually guaranteed returns – innovation theory trumps agency theory
- US government is the most formidable "developmental state" in history – e.g., NIH funding of the life sciences knowledge base – $706b. in 2009 dollars since 1938, annual budget currently $30b., double in real terms from mid-1990s
- Employees contribute to the innovation process, which by definition can only generate returns to the company in the future – employees engaged in the innovation process give their time and effort now with the expectation of future rewards, which are not guaranteed
- Claims to the "residual", i.e., the gains from innovative enterprise, give taxpayers and employees a direct economic role in corporate governance

The "dumb idea" is the dominant US *managerial* ideology

- As put forward by agency theory from the early 1980s, "maximizing shareholder value" was ostensibly a theory that supported the interests of shareholders
- But it was quickly **embraced as an ideology of top corporate executives** – legitimizes decisions that ignore the interests of employees and taxpayers in the name of shareholders, who, however, have little power in corporate governance: everyone agrees that boards of directors are chosen and controlled by incumbent management
- the use of stock-based compensation, and particularly unindexed stock options, to "align the incentives of executives" with shareholders has served to enrich top executives in the name of "maximizing shareholder value'

The "dumb idea" is a destructive ideology

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

- **Strategic control:** MSV permits separation of the interests of top executives from the interests of the corporation; they use MSV to justify the allocation of resources for their own personal gain
- **Organizational integration:** MSV undermines the incentives and abilities of the labor force to engage in collective and cumulative learning, which is the essence of the innovation process
- **Financial commitment:** MSV drains the company of financial resources needed to fund, and sustain, innovation – top corporate executives are "impatient capitalists" who make fortunes from exercising stock options – these executives do massive stock buybacks to manipulate their companies' stock prices

* See Lazonick, "The Chandlerian Corporation and the Theory of Innovative Enterprise"

Regaining control over the US corporation

- Put strict performance criteria, independent of stock price, on exercising stock options – e.g., job creation (so who needs stock options?) More generally, base executive pay on contributions to equitable and stable growth of the companies that they control
- Ban stock buybacks: force corporate executives to find productive uses for profits in the United States
- Transform boards of directors to include social representatives who seek equitable and stable growth
- Reject the ideology of "maximizing shareholder value": invoke innovation theory rather than agency theory as an intellectual foundation for governing the corporation
- It will require a revolution in social norms