NATIONAL TAXPAYERS UNION FOUNDATION

WHAT'S THE DEAL WITH...?

Issue Brief

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What's the Deal With Stock Buybacks?

As Democrats continue to cobble together a package that is likely to cost taxpayers $3.5 trillion, proposals for pay-fors are flying left and right. To help taxpayers and legislators navigate this plethora of potential tax hikes, NTU and NTUF are reviving the "What's the Deal With..." series to provide an in-depth look at specific issues. Already, NTU and NTUF have published reports on proposed changes to capital gains taxation, international taxation, corporate taxation, the child tax credit, energy taxes, prescription drug proposals, carbon tariffs, and the state and local tax deduction.

A frequent source of ire among progressives is stock buybacks, when publicly traded corporations use spare cash to buy back shares of stock from shareholders. According to critics of this practice, doing so rewards shareholders at the expense of more economically productive activities.

As a result, Senators Ron Wyden (D-OR) and Sherrod Brown (D-OH) are proposing a two percent excise tax on share buybacks, a move that the senators estimate could raise $100 billion over a decade. In addition to constituting a significant tax hike in uncertain economic times, this misguided tax proposal is based on a misunderstanding of the role stock buybacks play in the economy.

Background

Stock buybacks took center stage in the first few months of 2018, as the Tax Cuts and Jobs Act (TCJA) went into effect. Critics pointed to surging levels of buybacks, claiming to have identified the smoking gun that the revenue corporations saved from the TCJA's corporate tax cuts were being poured into rewarding shareholders, not improving the economy or raising wages.

This criticism revealed a deep misunderstanding of the goals of the TCJA. Critics of buybacks imagine a false dichotomy where corporations must choose whether to spend the revenue saved from lower taxes selflessly (towards increased wages) or selfishly (towards stock buybacks). To critics, increased spending on buybacks proves that corporations chose the "selfish" option, not the "selfless" one.

But it's simply false that corporations had this choice in front of them. While many corporations did indeed provide bonuses or even wage increases immediately in the wake of the TCJA's passage, this is a follow-on effect of the core of the TCJA: making it less expensive to invest in American business.

After all, the legislators behind the TCJA understood that what drives economic and wage growth is investment. Investments allow workers to become more productive via more efficient equipment and technology. This in turn makes them able to produce more value for consumers of the business' products or services, pushing their employers to raise their wages or see them get poached by another business willing to offer wages closer to market value.

But wage growth was always going to be a long-term effect, not one that should have been expected in the immediate aftermath of the TCJA. The vast majority of productivity gains from capital expenditures and investments would be reasonably expected to take place over a span of years, not months.

This is not to say that all critics of buybacks are so woefully misinformed. Some claim that buybacks take the place of capital expenditures, though they at least acknowledge the relationship between investment and wage growth. Fortunately, there's little evidence that this is the case.

The above view imagines that stock buybacks are a frivolous short-term way to spend cash. It sees them as something that keeps shareholders happy in the short term by pushing up stock prices, but is worse for the long-term than other options. In this view, stock buybacks are like donuts — a luxury that is bad for the long-term health of the corporation, but are just too sweet to avoid.

Ironically, stock buybacks are a fairly responsible corporate activity. The food analogy actually doesn't serve too well — it's not the case that buybacks are "healthy" in all circumstances. Rather, it's closer to the corporate version of depositing money in the bank. If there were productive investments to be made in the stock market, for example, you'd be better off making them. But if there aren't any productive investments to be made, you could do far worse things with your paycheck than depositing it in your savings account.

After all, a business that buys back shares does more than improve its stock price. It also provides itself room to reissue these purchased shares at a later date when it does need to finance new investments.

And the evidence shows that this is how corporations treat share buybacks. Rather than replacing investments, corporations buy back shares out of residual cash flow after opportunities for productive investments have been exhausted. One 2017 study by the Federal Reserve Board of Governors found no relationship between the level of share buybacks and dividends and investment expenditures.

In fact, one landmark study from the late 90s found that firms that perform stock buybacks outperform their competitors by 12.1 percent over the next four years, a finding that has been broadly repeated by more recent studies. This result should not be understood to suggest that stock buybacks are always beneficial — rather, it is likely because firms in a position to perform stock buybacks are in a better financial position than those that are not. Nevertheless, it does cast doubt on the premise that corporations engage in stock buybacks irresponsibly.

This dynamic of corporations returning capital to investors through buybacks when there aren't other, more productive investments also benefits the economy broadly. Corporations performing buybacks create more available investment capital for other businesses that *do* have productive investments to make. A shareholder benefiting from a stock buyback now has more resources to devote to investments elsewhere and on an economy-wide basis, this helps to drive investment dollars to new, innovative businesses that have opportunities available to them that a company engaging in buybacks may not. In this sense, buybacks allow the market to redirect investment capital from where it is not needed to where it is needed.

Critics of buybacks may counter that the fact that corporations had residual cash flow after making all available productive investments proves that the corporate tax relief offered by the TCJA was excessive. But despite ongoing efforts in Congress to undo as much of the TCJA as possible, the 2017 tax reform law was intended to underpin the tax code for decades, not just the years immediately following its passage.

While 2018 and 2019 may have been boom years that left some corporations with excess cash flow even after productive investments had been made, recession years like 2020, if not caused by the same circumstances, are to be expected as well. Generally speaking, looking at the effects of a sea change in tax policy over just a couple years is unlikely to be instructive.

The Impacts of a Buyback Excise Tax

The obvious impact of a tax on stock buybacks would be to discourage them. As shown above, this would push corporations to favor holding on to excess cash or disbursing it through dividends over buybacks, a rather arbitrary incentive for one method of benefiting shareholders over another.

It's often suggested that the stock market is the purview of the wealthiest Americans, closed off to the middle class. But this isn't exactly the case, meaning that discouraging buybacks could negatively affect the returns average Americans receive from investments.

As NTUF demonstrated in its last paper on share buybacks, the impact they have on stock values makes a significant difference in investment accounts held by a great many Americans. The latest Federal Reserve Survey of Consumer Finances (from 2019) shows that 53 percent of Americans hold publicly-traded stock in some form, with a median value of $40,000 in holdings. That roughly corresponds to the percentage of Americans who paid taxes that same year, 56 percent of Americans.

That's because even Americans who do not possess stock holdings in the traditional sense often do, in fact, participate in the stock market through retirement accounts, mutual funds, or pensions. These accounts are particularly important for seniors, for whom the median value of stock portfolios or retirement accounts is typically much higher. According to the latest census data (from 2017), the median senior stock and mutual fund account is worth $100,000, while the median retirement account is worth $124,300.

That's considerably more than the amounts from 2013, the latest data available when NTUF calculated significant increases to stock and retirement accounts for these groups as a direct result of the TCJA and increased buybacks. Back in 2013, the median stock portfolio among seniors was worth $73,300 and the median retirement account $113,300.

Based on these numbers, NTUF estimated the TCJA would result in an increased yield of $467 for the median senior's stock and mutual fund account over baseline, and an increased retirement fund yield of $723. Using updated 2017 data, these numbers would instead be $640 and $796, respectively.

An excise tax would reduce that return not only by the two percent that would go to the Treasury Department instead of shareholders, but by reducing the incentive for corporations to perform buybacks in the first place. Combined with other changes to corporate taxes such as proposed rate hikes and a more restrictive international tax framework, buybacks could be expected to drop substantially.

Revenue From Buybacks

Senators Wyden and Brown are estimating that a two percent excise tax on buybacks would raise around $100 billion over the next decade. This appears to be the result of a simplistic calculation taking two percent of the $5.3 trillion corporations have spent on buybacks over the last decade.

If this is the case, this is foolishly optimistic. Should Democrats pass their tax reform plans, we can expect buybacks to decrease sharply. Not only would they be directly discouraged through the two percent excise tax, but corporations would have reduced cash flow from increases to corporate tax rates, efforts to make U.S.-headquartered multinationals more internationally competitive would be undone, and capital gains tax hikes would discourage investment.

All told, corporations would be left with less spare cash to put towards buybacks, and the tax code would discourage them from using what cash they did have on buybacks. Smart tax policy should never simultaneously disincentivize an activity and count on revenue from its taxation — especially when the choice to disincentivize it is arbitrary in the first place.

Conclusion

Targeting stock buybacks for tax hikes may please the Democratic base, but it makes little sense in terms of tax policy. Tax hikes motivated by politics rather than sound tax or economic policy are rarely a recipe for success.

Instead of searching constantly for new things to tax, perhaps Democrats should ask themselves, as the second consecutive year with projected deficits over $3 trillion comes to a close, if the priority should be seeking to fund massive new spending initiatives. Responsible custodians of taxpayer dollars should focus on not burying future generations in debt.

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