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What Do Stock Buybacks Mean for the Economy?

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Introduction

The Tax Cuts and Jobs Act (TCJA) passed last year cut the corporate rate from 35 percent to 21 percent and left corporations with substantially more money - to spend, to invest, to divest to workers - and what they would do was the subject of much debate. The way that the corporate tax cuts would affect the economy was key to understanding the legislation.

Soon after the passage of the TCJA, I predicted that the incentive structure created by the tax reform law would lead many business leaders to invest in their businesses. This has turned out to be the case, with hundreds of major businesses extending bonuses, increased 401(k) contributions, and wage increases to workers. At the same time, some have suggested that the greater benefit will be to corporations, who will "spend money on themselves" by buying back shares of stock and extending dividends to shareholders.

Critics of the tax reform law have pointed to record levels of stock buybacks to suggest that corporations are the big winners of tax reform. Yet this criticism makes several assumptions that misunderstand the economic argument for corporate tax cuts and the role that buybacks and dividends payments have on the economy.

First and foremost, temporary bonus payments are just that: a bonus, not the real boost to wages that economists predicted. Wages will grow over time as businesses invest in improvements that allow each worker to produce goods or services more efficiently. The process of making investments will benefit a business in the long run and realizing productivity enhancements from those investments is a slow one. The payoff of increased wages will not be instantaneous but will be realized as those investments are made. Comparing stock buybacks to worker payments, with the implication that lowering the corporate tax rate can only benefit workers in the form of short-term bonuses, misunderstands what makes wages rise.

The further assumption that stock buybacks are unhelpful to the economy requires a deeper dive. Stock buybacks do not benefit the average American as directly as an increase to worker take-home pay, perhaps, but they do benefit American workers and the economy as a whole in other ways.

The Impact of Stock Buybacks on Shareholders

The primary impact of a share buyback, particularly when a company's stock is undervalued, is to raise the value of that stock. Because share buybacks reduce the supply of shares in market, each remaining share held by investors becomes more valuable. In a case such as this, with corporations across the stock market buying back substantial amounts of stock, prices can increase across the market.

A closer look at the demographics of stock owners reveals that a majority of Americans have a financial interest in a strong stock market. The Federal Reserve Board of Governors found that 52 percent of Americans owned stock in 2016, either directly or through a retirement fund, mutual fund, or pension. This number corresponds roughly to the number of Americans who paid income taxes in 2016 (56 percent.)

A strong stock market is particularly important to Americans when thinking about retirement. Nearly 60 percent of working-age Americans hold a personal retirement account, be it an IRA or a 401(k). The TCJA has also spurred increased dividend payouts.

Dividend payments and share buybacks can contribute meaningfully to seniors' income. NTUF calculated the percentage of the market capitalization of the S&P 500 that went towards share buybacks and dividend payments in order to establish a pre-tax reform shareholder yield baseline. With roughly $515 billion in share buybacks and $415 billion in dividend payouts in the four quarters prior to the enactment of tax reform, the baseline shareholder yield is roughly 4.32 percent.

Dan Clifton, an expert at Strategas Securities, estimated to NTUF that share buybacks would increase to $800 billion and dividend payouts would increase 15 percent to $477 billion in 2018. If growth in the S&P 500's market cap keeps pace with average growth over the past five years, this would result in 4.96 percent shareholder yield. However, as market cap growth rates fluctuate wildly, NTUF estimates that shareholder yield could be between 4.66 percent and 5.33 percent—though due to the passage of the tax reform law, the higher bound is more plausible.

The median stock and mutual fund investment portfolio for seniors is $73,300.[1] Prior to the passage of the TCJA, the portfolio would yield $3,167.86. Post-tax reform, NTUF estimates that this number would increase by approximately $465 to $3,620.80.

Seniors benefit more from dividend income than any other age group. Americans 65 or older made up 40 percent of households receiving dividend income in 2015, the last tax year for which data is available.[2] That same year, seniors received 53 percent of all dividend income.

Meanwhile, roughly half of retirement-age Americans have retirement accounts. The median value of these portfolios is around $113,000.[3] Prior to the passage of the TCJA, this portfolio would yield $4,881.60. Following the tax reform law, NTUF estimates that the median retirement account portfolio would yield an additional $723.20. Share buybacks and dividend yield increases directly help more than just CEOs and the wealthiest Americans.

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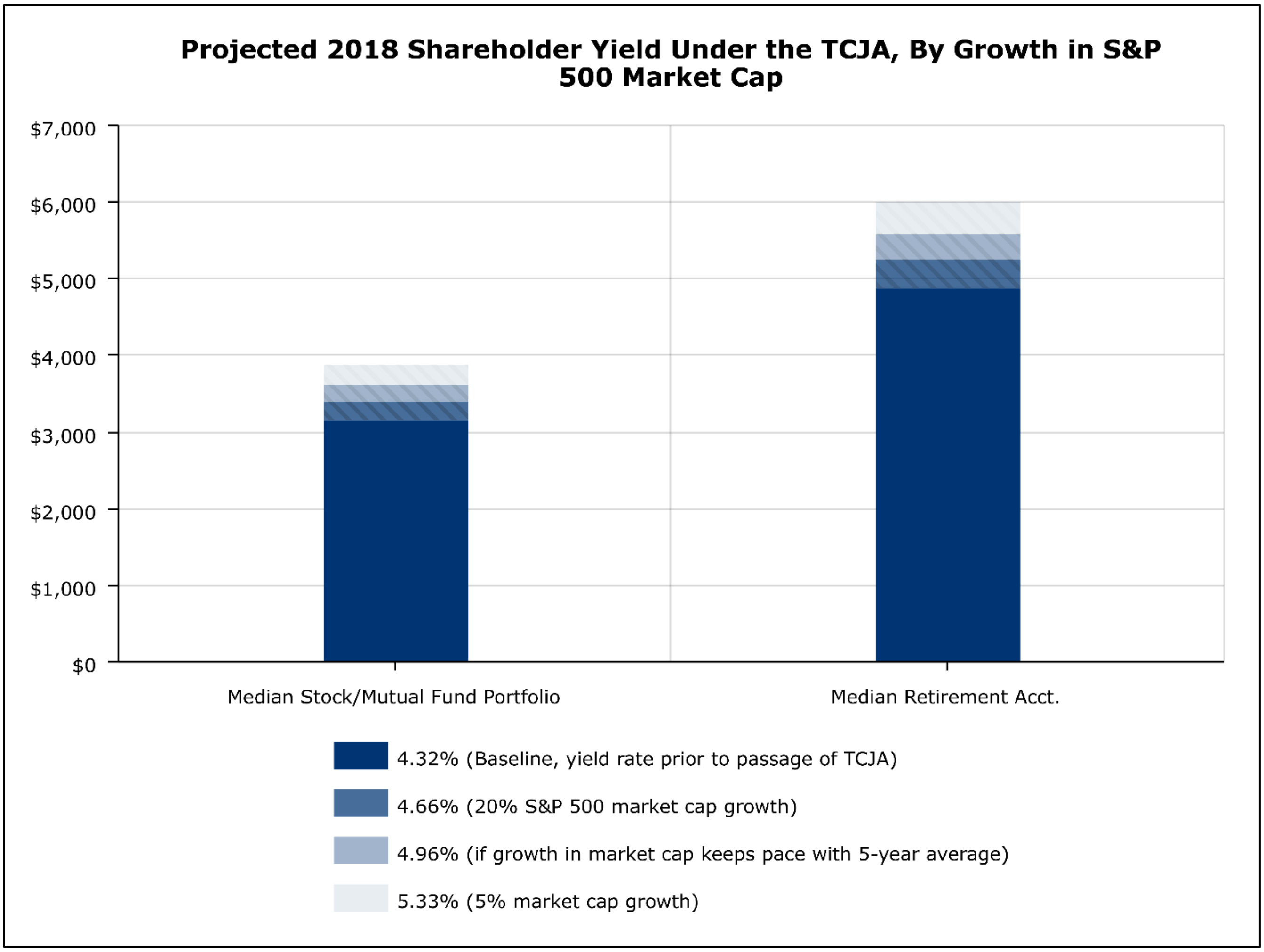
[1] Census Bureau Survey of Income and Program Participation, 2013, available at https://www.census.gov/data/tables/2013/demo/wealth/wealth-asset-ownership.html
[2] IRS Statistics of Income, Table 1.5 All Returns by Age, Tax Year 2015
[3] Census Bureau Survey of Income and Program Participation, 2013, available at https://www.census.gov/data/tables/2013/demo/wealth/wealth-asset-ownership.html



<u>Projected 2018 Shareholder Yield Under the TCJA, By Growth in S&P 500 Market Cap</u>

	4.32% (Baseline, yield rate prior to passage of TCJA)	**4.66% (20% S&P 500 market cap growth)**	**4.96% (if growth in market cap keeps pace with 5-year average)**	**5.33% (5% market cap growth)**
Median Stock/Mutual Fund Portfolio	$3,153.60	$3,401.80	$3,620.80	$3,890.90
Difference in Stock/Mutual Fund vs. Baseline	*N/A*	*$248.20*	*$467.20*	*$737.30*
Median Retirement Account	$4,881.60	$5,265.80	$5,604.80	$6,022.90
Difference in Median Retirement Acct. vs. Baseline	*N/A*	*$384.20*	*$723.20*	*$1,141.30*

The Impact of Stock Buybacks on the Broader Economy

Share buybacks have an impact on the economy as a whole as well. Contrary to the belief that buybacks are a form of corporations thinking short term, buybacks can be a productive form of long-term growth for businesses. There is little evidence that corporations are overly short-term oriented. Surveys of financial executives suggest that, rather than taking the place of other investments, corporations tend to engage in share buybacks only in the absence of more productive investment opportunities. The economic evidence supports this as well—researchers have been unable to prove a connection between share buybacks or dividend yield increases and decreased economy-wide investment.

Share buybacks are beneficial to the economy. Businesses that engage in buybacks have been shown to beat their competitors by 12.1 percent over the next four years. Of course, this is partly due to the fact that buybacks are a sign that a business has made all investments that make sense and has surplus cash, and thus is inherently well-positioned for success. Yet buybacks also represent a way to avoid wasting capital; by buying back shares of stock, a corporation gives itself more room to maneuver should future sales of stock to raise funds for investment become necessary.

This is good for the economy as a whole as well. Rather than wasting capital on less productive investments, companies return it to investors by engaging in shareholder distributions. Investors can then redistribute this income to businesses seeking to raise capital for more economically useful investments.

This informal mechanism for redistributing investment funds through the stock market is particularly useful in the context of other changes to the corporate tax code made by the TCJA. Full expensing, for example, allows businesses to immediately deduct the cost of new capital investments (such as equipment or buildings) rather than using a complicated and drawn-out system of depreciation.[4] Under the TCJA, full expensing will be in place for the next five years, meaning a great deal of businesses will be looking to increase capital investments. However, some industries have fewer capital investment opportunities and thus won't benefit full expensing as much. Additional share buybacks encouraged by tax reform can enable industries with less potential to benefit from full expensing to nonetheless benefit from tax reform by investing in their stock.

Conclusion

Shareholder distributions such as share buybacks and dividend yield increases are not the economic sinkhole that some pundits suggest. They provide meaningful income boosts to the majority of Americans with a financial interest in the state of the stock market, as well as a means of making capital investment more productive and efficient throughout the stock market. The benefits of the TCJA will be realized over the long term, and dismissing tax reform as a failure because of an uptick in stock buybacks would be a mistake.

About the Author

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[4] For more on why full expensing drives investment growth, see https://www.ntu.org/foundation/detail/whats-the-deal-with-full-expensing