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Buybacks Aren't the Problem!

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The environment on Capitol Hill has made populism a bipartisan affair, with Republican Senator Marco Rubio now joining the fray with a call to tax corporate stock buybacks.

His argument? Corporations are buying back stock instead of making productive investments. He's not alone in arguing that weak investment is the reason the economy isn't growing faster. Meanwhile others argue the corporate tax cut of 2017 fell flat as tax savings went towards a surge in buybacks, not investment.

Rubio also bemoans that stock buybacks face a lower tax rate than dividends. But qualified dividends (which are the vast majority of dividends paid by public companies) are taxed at the same rate as capital gains, so we're not quite sure how he comes to this conclusion.

Let's break down the issues with his argument. To start, companies have been investing. Think about it. If companies were under-investing, there would be shortages, and that is simply not the case.

Another reason his argument fails scrutiny – and probably the most common misperception when it comes to corporate investments – is that people mistake nominal investment for real investment.

The price of technology has fallen dramatically while its capabilities have surged. You can buy a smartphone or tablet today for hundreds of dollars, while just a decade ago those embedded technologies would have cost millions of dollars (and required a suitcase to lug around). Airlines can now book passengers using an App instead of a ticket office. Brick and mortar stores are being replaced by logistics software and delivery vehicles. A decade ago it took more than two months to frack a well, now it takes two weeks.

In other words, the price of production is falling while profit margins have improved. The declining costs for improved performance make it appear that companies aren't investing, when in reality they are. In fact, productivity at the corporate level is booming, and that's exactly why corporations can return so much capital to shareholders. On a nominal basis, business investment was 13.7% of GDP in the last quarter of 2018, exactly where it was in 2001 and 2008. But on a real basis (where inflation – or in the case of technology, deflation -is accounted for), business investment was 14.7% of GDP, the highest on record.

It's this lack of perspective that has people pining for the past. And it makes no sense. If it took longer to frack a well, companies needed office space to sell airline tickets, or we had no online retail, then yes, investment would be higher, but then profits would be lower. But we guess Rubio's "problem" would be fixed, as companies wouldn't have the profits for stock buybacks or dividends.

Now to address the second misperception. Both buybacks and dividends reduce cash on corporate balance sheets. As economist John Cochrane has explained, a buyback does not necessarily leave a remaining shareholder in a better position. Let's say a company has two shares in circulation, $100 in cash, and assets capable of producing future profits worth $100 today. Each of the two shares should be worth $100. If the cash is used to buy back one share, there would only be one share remaining and $100 in future profits, so the share should still be worth $100. If the company paid a dividend of $100 ($50 per share), the price of each share would fall from $100 to $50, creating a capital loss of $50. If the shareholder took the loss it would offset the tax on the dividend. Either way, the government captures zero dollars.

Simple math says that, either way, profits for shareholders and tax receipts should not be different as long as capital gains and dividends are taxed equally. And if a politician believes one is taxed less than the other, we think that politician should find a way to reduce the higher tax rate, not raise the lower one. Cutting tax rates is the best way to boost incentives for work, savings and investment.

Finally, the government has proven itself a terrible fiduciary. In 2017, after eight years of economic recovery, and before the Trump corporate tax cut went into effect, the budget deficit was $680 billion. Even John Maynard Keynes must have been rolling over in his grave. So, why would anyone trust government to start telling private citizens what to do with their own money?

Can you imagine politicians telling you that you aren't allowed to pay down your mortgage because your after-interest income would be too high if you did?

In the end, government needs to focus on fixing its own fiscal house rather than trying to manage the private sector. While it's always possible to find some corporate managers who make bad decisions, a vast majority of them are very responsible in their fiduciary duties. In the past decade they have done well by their shareholders. It's politicians that have failed in their fiduciary duties. No matter which side of the aisle they hail from, interfering with private decisions is wrong.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-19 / 9:00 am	Factory Orders – Jan	+0.3%	**+0.6%**		+0.1%
3-21 / 7:30 am	Initial Claims Mar 16	225K	**225K**		229K
3-22 / 9:00 am	Existing Home Sales – Feb	5.100 Mil	**5.040 Mil**		4.940 Mil