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Abstract

Many economists have argued that equity markets are characterized by myopia. Investors want immediate returns, and the managers of publicly traded funds are induced to sacrifice long-term growth in order to give it to them. In this paper, I explore the "short-termism" argument, survey the weak empirical evidence for it, and critique several proposals which have been advanced as a corrective to it.

1 Introduction

Lawrence Summers and Larry Fink, Joseph Biden and Elizabeth Warren, the Center for American Progress and the McKinsey Global Institute. An eclectic group, to be sure, but they can all agree on one thing: U.S. shareholders are too myopic, and it's hurting the economy. But it's not investors' fault. They are rationally responding to the incentives before them. It just so happens that short-termism is an essential outcome of free-market capitalism. Without a regulatory liferaft, shareholders and corporate managers alike will be trapped in the powerful undertow of quarterly capitalism.

Contra the proponents of the "efficient markets hypothesis", who argue that prices on the stock market incorporate all extant information about a firm's current and expected future profits - discounted accordingly - there exists a considerable economics literature that grants the premise that shareholders are rational, but posits that this *individual* shareholder rationality does not aggregate to rationality at the *market* level. One such market failure is said to obtain in publicly traded equities, known variously as "short-termism, "quarterly capitalism", or, more formally, the "myopia hypothesis."

While accusations of stock-market short-termism are intellectually buttressed by different arguments[1], the most common strain of the "myopia hypothesis" proceeds as follows: the managers of publicly traded firms, whose shares trade in

[1] In 1989, economist Jeremy Stein published a highly influential article titled Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior. It explicates a model in which corporate managers are trapped in a prisoner's dilemma vis-a-vis other managers. Anticipating that investors will use current earnings as the best forecast of future earnings, each manager is eager to unilaterally inflate the next earnings report and thereby reap an advantage in attracting equity capital. This can be accomplished by relatively innocuous accounting gimmickry, or by genuinely harmful dereliction of longer-term investments. The systemic effect of these individually rational strategies is an equilibrium in which all short-term earnings are inflated but to nobody's advantage. This is but a particular strain of a larger literature, which details the various mechanisms by which share prices may be caused to deviate from fundamentals without alleging that investors are irrational (a school of thought with a similarly impressive pedigree, with seminal contributions from Robert Shiller, Brad DeLong and Lawrence Summers).

deep and liquid markets, are hostage to the over-diversified and under-informed marginal shareholder, who moves the share price not in response to new information about a firm's fundamentals, but in response to the latest, easily digestible quarterly earnings report. Instead of undertaking investments in the present that might have a substantial return several years down the road, managers are induced to mimic the priorities of transient shareholders uninterested in a firm's long-term strategy. Future-oriented firms that resist this temptation will be penalized, finding it more difficult to raise capital. This will in turn affect their bottom line, jeopardizing their ability to even survive to the point at which they would reap the returns from their long-term investments.

A variety of legal remedies have been proposed to combat short-termism: from relatively minor vesting restrictions on executive stock options to a wholesale paradigm shift from our free-wheeling "liberal market economy" to a Franco-Germanic-Japanese style "coordinated market economy" in which patient, far-sighted institutional bloc-holders substitute for a dispersed set of myopic, over-diversified shareholders.[2] While few policymakers have the stomach to rearrange our economy's institutional innards in such a wholesale fashion, more "modest" proposals are advanced (and often achieved) by figures such as Barack Obama and Elizabeth Warren on a routine basis.[3]

The myopia hypothesis predicts that: 1) stock markets will undervalue firms that sacrifice short-term profitability for longer-term growth 2) firms will therefore rationally forego long-term investments such as research and development (R&D) and capital expenditures (CAPEX), 3) firms will disgorge their cash to shareholders instead of reinvesting it, and 4) by implication, an economy whose corporate sector is more reliant on equity financing, particularly when mediated by liquid, public markets, will exhibit these pathologies to a greater degree than

[2] Hall and Soskice (2000) "Varieties of Capitalism"

[3] Eg Elizabeth Warren's Accountable Capitalism Act and the incorporation of say-on-pay mandates in the Dodd-Frank Act, more in Part II, Section II, infra

an economy with a less equity-financed corporate sector.

In this analysis, I will dispute the empirical evidence for each of these claims. After establishing that the empirical case for short-termism is circumstantial at best, I will proceed to discuss two distinct sets of policies that have been proposed to remedy the resulting (alleged) harms: 1) restrictions on share buybacks and 2) corporate governance reforms. I will then survey the economic literature by which we may infer the impact each proposal is likely to have and conclude by arguing that such remedies will ultimately be iatrogenic.

2 Empirical Evidence Inconsistent with Short-Termism

2.1 Profits, P/E Ratios and IPOs

Several economic indicators present themselves as a challenge to the first pillar of short-termism thesis. In a recent NBER working paper, Steve Kaplan contrasts the early, strident predictions of the myopia theorists in the 1980s with subsequent trends in corporate profits. If the short-termists of yesterday had been correct, the earnings posted by publicly held firms throughout the 80s and 90s would have evaporated over the medium-to-long term. Instead, we've since witnessed a steady upward march of corporate profits into now unprecedented territory.[4]

Moreover, while earnings have been on the rise over the past several decades, the price-to-earnings ratio (P/E) of the median firm listed on the SP has risen even faster, currently at 25 compared to a historical median of 15.[5] A higher P/E ratio indicates that shareholders are valuing *future* earnings very highly.

[4] Kaplan (2017)
[5] ibid

The very names that come to mind when one thinks of dynamic, future-oriented firms: Google, Apple, Amazon, Microsoft, Facebook all have exceptionally P/E ratios (35), in many cases despite year-long draughts in the red (Amazon netted more income in the final quarter of 2017 than in all 54 post-IPO quarters cumulatively). Investors have no doubt that today's unexceptional profits are going to grow substantially over the coming years and are pricing this optimism into current share prices. For these five firms, total profits of $101 billion in 2017 translated into a valuation worth 15% of the *entire* S&P 500.[6] The latest "Special Report" of the *Economist* magazine, while describing the potential monopoly threat that these tech giants pose, nonetheless concedes that their currently stratospheric valuations are in anticipation of *future* profits:

> To justify its valuation, Facebook's rate of "monetisation" will have to surge, suggesting that it extracts a bigger fee from other firms who want to reach consumers. To justify its $820bn market value, Amazon will have to increase its share of American retail to 12% (Walmart's share today is 7%). Likewise Netflix will have to roughly double its nominal fee per user over the next ten years. Though tech firms' profits as a share of gdp today are not extraordinarily large, Wall Street is predicting they will be in a decade's time, with the median ratio for the five firms rising to 0.28%. That is above the 0.24% median level of Standard Oil, us Steel, att and ibm when they were each clobbered by antitrust regulators. The tech firms are expected to have higher returns on capital than the oligopolies of old, suggesting that they are better at extracting income per dollar of assets.

The *Economist* goes on to elaborate the ways in which prominent firms are leaving money on the table in the short-term in order to build future market-share:

> For Amazon and Netflix the rents flow in the other direction because their prices are low today: in total they subsidise their combined 240m paying subscribers to the tune of about $50 per person per year, based on the amount of additional free cashflow they would have needed to cover their cost of capital in 2017.

Further corroboration can be found in the timing of IPOs. Notable exam-

[6] Roe (2018)

ples such as Uber notwithstanding, the overall trend in IPOs has been toward more and more “premature” births of firms into public markets. The average profitability of a firm at the date of its IPO has been declining over the past several decades, as investors are willing to purchase shares in firms earlier in their life cycle[7]. Kaplan, citing IPO statistics by Jay Ritter, notes that just 4% of biotech firms that had an IPO between 2013-2016 were posting profits at the time. If publicly traded companies were indeed hobbled by myopic shareholders, this would present a massive arbitrage opportunity for investment vehicles operating on a longer time horizon. Venture capital and private equity funds are equipped for this purpose, yet have not seen the abnormal profits or increased marketshare that one would expect if publicly traded firms were consistently failing to anticipate trillion dollar bills a few steps ahead on the sidewalk.[8]

2.2 R&D Up not Down in Public Firms

The second key piece of evidence militating against the myopia thesis is that publicly traded U.S. firms, *particularly* those with the bubbliest valuations, are conducting more R&D than ever before, not less. Let’s begin by noting the strong, secular trend upward in the overall private sector’s spending on R&D, which I’ve divided by total GDP (known as “R&D Intensity”):

[7]Fama and French, 2004; Ritter, 2016; cited in Kaplan, 2017
[8]Supra note 5

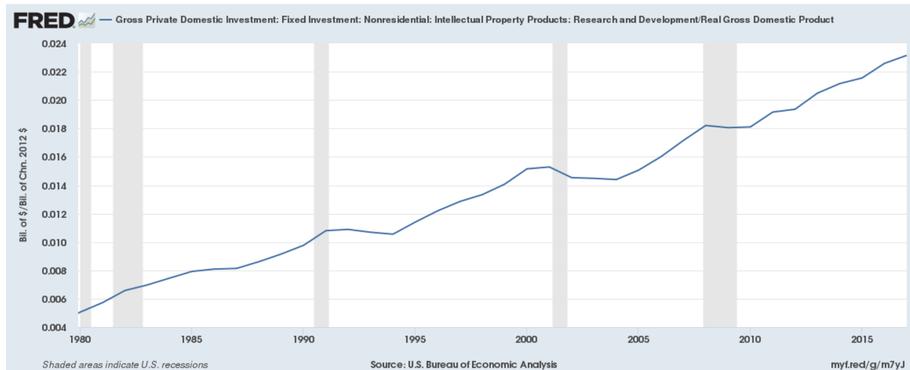

Figure 1: Private Sector R&D

Next, let's look at R&D spending by the five aforementioned firms, that shareholders are tripping over themselves to invest in:

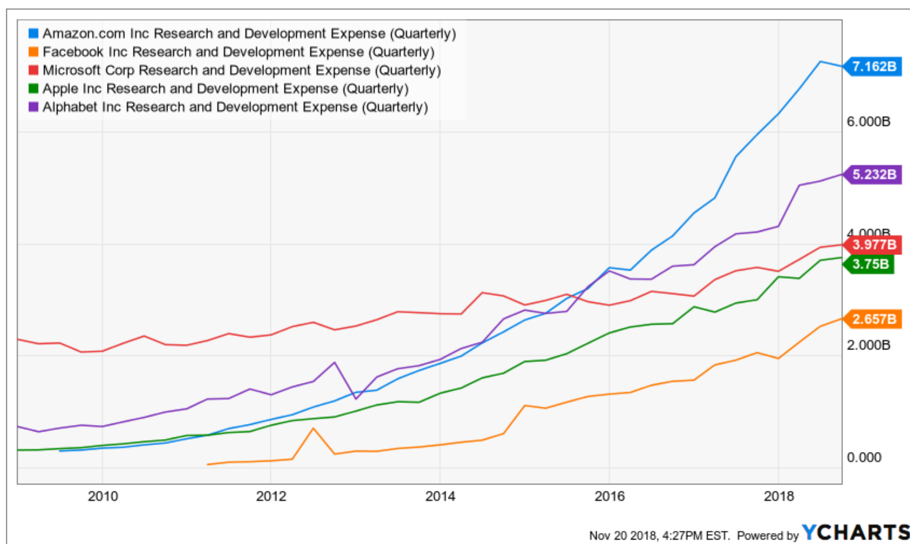

Figure 2: R&D spending for Alphabet, Amazon, Facebook, Microsoft and Apple

The only way to reconcile the myopia hypothesis with the foregoing data is to maintain that these firms' valuations would be *even higher* if they were spending less on R&D. For some reason, that counterfactual rings false. Post-recessionary declines in capital expenditures, on the other hand, seem superficially sympa-

tico with short-termism, but can be adequately explained by reference to lower capacity utilization, and is in fact a worldwide phenomenon not restricted to the "overly financialized" Anglosphere.[9]

Let's recall the mechanism by which short-termism is said to operate: diversified, rationally ignorant shareholders with short time-horizons turnover at high rates and punish future-oriented investments that incur immediate costs, such as R&D. We would expect, therefore, that publicly traded firms, whose shareholder profiles check those boxes, would suffer more acutely from myopia than privately held firms. Indeed, studies have found that publicly traded companies that go private register more patents post-transition, and, conversely, that privately held firms suffer a decline in patent quality after an IPO.[10][11] More directly to the point, a 2015 paper found that compared to privately held firms matched on a battery of relevant characteristics, public corporations engage in less net investment, and are less likely to capitalize on new investment opportunities as they emerge.[12]

A 2018 Federal Reserve Board working paper, armed with corporate tax return data, comes to the opposite conclusion. Because private and public firms are subject to the same IRS filing requirements, the researchers were able to achieve a far higher degree of inter-group measurement consistency than previous studies. Moreover, whereas the Asker et al paper only had access to an unrepresentative sample of private firms and had to combine their measurement of capital expenditures with merger and acquisition activity as a rough proxy for net investment, the FRB study's IRS data allows it to directly measure long-term investment, and to divide this measure into its physical and intangible (R&D) components. Beyond being far more granular, this dataset also

[9] Supra note 7
[10] Lerner, Sorensen and Stromberg (2011)
[11] Bernstein (2015)
[12] Asker, Ferre-Mensa, and Ljungqvist (2015)

captures the full universe of private U.S. corporations, allowing the researchers to compare a *representative* sample of private firms against their publicly traded counterparts, mitigating the selection effect that has plagued past comparisons. Not only do the Fed researchers find statistically significant *inter*-firm differences between private and public firms, the magnitude of these effects is substantial:

> ...public firms invest...46.1 percentage points more in long-term assets than their private firm counterparts. It is not simply that public firms invest more relative to their asset base and thus out-invest private firms, they also direct a greater share of their investment portfolios to long-term assets. Public firms allocate 9 percentage points more of their total investment dollars to long-term assets than comparable private firms. The long-term investment advantage of pubic firms over private firms largely stems from their outsized investments in R&D. Public firms invest 39.2 percentage points more in R&D expenditures relative to physical assets, and dedicate 11 percentage points more of their investment budgets towards R&D than private firms.[13]

Moreover, the researchers directly attribute this result to the difference in the shareholder profiles facing private vs. public firms:

> The access to capital investment and the ability to spread risks among many small shareholders appears to facilitate heavier investments in RD, arguably the riskiest of asset classes.

This result does not appear to be the artifact of an omitted variable confounding the comparison between private and public firms. By exploiting intra-firm variation pre and post-IPO, the researchers similarly note:

> We find that public firms do not alter their short-term investment relative to physical assets following an IPO. These firms do, however, increase their long-term investments, and particularly investments in RD: firms increase their R&D-to-physical asset ratios by 34.5 percentage points, and their R&D-to-total investment shares by 17.1 percentage points. Using an event study framework, we show that this increase in RD expenditures occurs immediately upon IPO and persists for at least 10 years. We also examine changes in investment behavior following stock market delistings: results are less precise, but generally point to a reduction in RD investments upon going private.

[13] Feldman et al 2018

2.3 Stock Buybacks

If corporations are disincentivized from reinvesting their profits into the firm, as the short-termists claim, what are they to do with their earnings? Disburse them to shareholders, either in the form of dividends or share buybacks. Shareholders force corporations to eat their seed corn without a thought for next year's harvest. The lower a firm's free cash flow, the less ability it retains to take on new investments, even those with a high net-present-value. But no matter: the corporate form is not to be treated as the vehicle for the transformation of debt and equity into a value-added product, but as a piñata full of cash.

There is no shortage of hand-wringing over "excessive" stock buybacks, either in the academic literature or in the popular media. Such criticisms are misguided in two crucial ways. Methodologically, they overstate the scale of the problem (such as it is) by observing gross payouts instead of payouts net of issuance, and by neglecting the extent to which firms are simply substituting low-interest debt for equity financing. Second, while accusing shareholders of being myopic in demanding buybacks and dividends, such critics are not taking a properly panoptic view of the function that buybacks and dividends serve in the broader equity ecosystem (more on this in Part II, Section I. infra).

Harvard researchers Jesse Fried and Charles Wang offer a persuasive rejoinder to concerns over the scale of equity outlays:

> During 2007-2016, S&P 500 firms distributed to shareholders more than $4.2 trillion through stock buybacks and about $2.8 trillion through dividends. These cash outflows, totaling $7 trillion, represented 96% of these firms' net income during that decade. But during this same period, S&P 500 firms absorbed, directly or indirectly, $3.3 trillion of equity capital from shareholders through share issuances. Net shareholder payouts from S&P 500 firms were therefore only about $3.7 trillion, or 50% of these firms' net income.[14]

This figure pertains only to those firms listed on the S&P 500, which are

[14] Fried and Wang (2018)

relatively mature, vs. publicly traded firms not listed on the index. When accounting for unlisted public firms, who are net importers of capital, the share of corporate income channeled into buybacks and dividends falls further, to 41%.[15] Moreover, net equity outlays don't necessarily translate into a reduced cash position. Low interest rates mean that firms can afford to reorient their balance sheets away from equity and toward debt financing. In fact, in the years 1989-2012, fully 42% of equity payouts were offset by a debt issuance that same year.[16] In a recent working paper, Mark Roe discusses the shift from equity to debt:

> Low interest rates pushed corporate America to substitute low-interest debt for stock. Viewed as a capital structure decision, the double trend—more low-interest debt, less equity—fits the short-termist critique poorly. Overall, public firms have more cash, not less.[17]

Not only do public corporations retain more of their earnings than is indicated by gross equity outlays (including debt financing, total corporate cash balances *rose* from $3.3 to $4.5 trillion between 2007-2016[18]), there is evidence to suggest that this extra liquidity is flowing into long-term investments such as R&D. Again quoting from Fried and Wang:

Further, we show that public firms deployed much of this capacity for investment in R&D and CAPEX. In absolute terms, total investment (R&D and CAPEX) rose to a record level. And relative to revenues, total investment rose to levels not seen since the late 1990s economic boom.

If anything, these large gross capital movements, and net equity outlays, are a sign of economic efficiency, not destructive short-termism. As John Cochrane explains in the Wall St. Journal, if Company A is short on investment ideas but long on cash, and Company B is facing the opposite situation, a share buyback

[15] ibid
[16] Farre-Mensa, Michaely, and Schmalz (2018)
[17] Roe (2018)
[18] Fried and Wang 2018

allows investors to reallocate their capital to its higher-value use (in the hands of Company B).[19]

2.4 Cross-Sectional Comparisons

If overly diversified, impatient investors demand the prioritization of the upcoming earnings report, then firms that are more reliant on such investors will be more likely to exhibit short-termism, and, *a fortiori*, the average firm in an economy more reliant on such investors will engage in long-term investments at lower rates than the average firm in an economy that is less reliant on liquid equity markets.

The most recent evidence indicates that publicly traded firms, reliant on relatively footloose investors, engage in *more* long-term investment and R&D spending than comparable private corporations.[20] The cross-sectional data comparing corporate financing in the U.S. corporate sector against the more concentrated, longer-term and less liquid capital markets of Europe similarly confounds the myopia thesis. Despite its greater structural susceptibility to short-termism, the U.S. corporate sector spends nearly double the percentage of its income on R&D than does its E.U. counterpart, and the resulting productivity gains are substantially greater.[21] Secular trends in capital investment (CAPEX) also fail to corroborate this narrative. Mark Roe compares CAPEX spending since 1970 in U.S. with other OECD countries, as well as the notoriously bloc-holding, cradle-to-grave financing champions Germany and Japan. The result? A roughly flat trend line for the U.S., pulled down by the recession, vs. steeply negative slopes for the OECD, Japan and Germany.

[19] Op-ed March 5, 2018, more in Part II, Sec. I, infra
[20] supra, sec. II
[21] Castellani et al 2018

3 Remedies to Short-Termism: A Critique

3.1 Stock Buybacks: Theory

In March of this year, *Forbes* published an article with the following lede:

> The *Economist* has called them "an addiction to corporate cocaine." *Reuters* has called them "self-cannibalization." The *Financial Times* has called them "an overwhelming conflict of interest." In an article that won the HBR McKinsey Award for the best article of the year, *Harvard Business Review* has called them "stock price manipulation." These influential journals make a powerful case that wholesale stock buybacks are a bad idea—bad economically, bad financially, bad socially, bad legally and bad morally.

In many progressive circles, share buybacks are a hair's breadth from outright fraud. Legally ambiguous prior to a 1982 rule change by the SEC that provided clear "safe harbor" provisions for the practice, buybacks have since become a key tool in corporate finance.[22] Forbes' Steve Denning, articulates buybacks' contribution to short-termism:

> [Corporate executives] hit upon a magic shortcut: why bother to create new value for shareholders? Why not simply extract value that the organization had already accumulated and transfer it directly to shareholders (including themselves) by way of buying back their own shares? By reducing the number of shares, firms could, as a result of simple mathematics, boost their earnings per share. The result was usually a bump in the stock price—and short-term shareholder value.

Rather than serving a sensible capital rebalancing purpose, such critics claim that buybacks are used to game the next earnings report and appease shareholders. By reducing a corporation's cash (an asset), buybacks increase Return on Assets (ROA) as well as Earnings per Share (EPS) by reducing the denominator (shares outstanding).

For many academics and policymakers, stock buybacks are not merely *presumptively* illegitimate, but are illegitimate *per se*. William Lazonick, in the aforementioned (award-winning) Harvard Business Review article "Profits with-

[22] Rule 10b-18

out Prosperity", states bluntly that "the reasons commonly given to justify open-market repurchases *all* defy facts and logic" (emphasis mine). He goes on to claim that "the only plausible reason for this mode of resource allocation" is the cupidity of corporate executives. He is similarly forthright in his prescription:

> The American public should demand that the federal government agency that is supposed to regulate the stock market rescind the "safe harbor" that enables corporate executives to manipulate stock prices. . . the SEC may well be advised to make open-market repurchases illegal.[23]

In a similar jeremiad against the practice in the American Prospect magazine, Lazonick cites the growing support for such restrictions among prominent U.S. politicians:

> A number of Democratic senators, including Tammy Baldwin, Elizabeth Warren, Bernie Sanders, Brian Schatz, Charles Schumer, Chris Van Hollen, Cory Booker, and Sherrod Brown, have voiced criticisms of buybacks, as has former Vice President Joseph Biden.

But is it possible that share buybacks serve a legitimate financial function? If so, any restrictions on corporations' ability to restructure their liabilities in this way will have negative consequences that may completely offset any salutary effects such a restriction might have.

Because share prices often rise in anticipation of an announced buyback program, critics claim that corporate executives repurchase shares to goose the company's short-term valuation, to which their own stock options are tied. But this same empirical pattern is also consistent with a properly incentivized management returning cash to shareholders when the company lacks investment opportunities with sufficiently high net present values.

As Hoover fellow John Cochrane explains, not every firm in the economy faces the same spectrum of profitable investment opportunities at the same time. It is therefore efficient for cash to flow from those firms that have the

[23] Lazonick (2014)

lower marginal returns on investment to those that have the highest. Skeptics of this argument maintain that these "mature" firms with a supposedly reduced need for cash will instead, by virtue of their longevity, have developed "dynamic capabilities" that would allow them to exploit a functionally inexhaustible set of investments whose returns exceed the hurdle rate.[24] But even ignoring organizational diseconomies of scale and granting this heroic assumption, we cannot wish away one of the core features endemic to the relationship between a corporation's shareholders and its managers: agency costs.

Because a corporation's management does not fully internalize the impact of its actions on the firm's share price, there exists an incentive misalignment vis-à-vis shareholders.[25] Managers are perennially tempted to allocate the firm's resources towards assets that do not benefit shareholders, but instead increase managerial consumption (in Cochrane's example, a fleet of corporate Ferraris.) Such waste need not be so conspicuous, however. Subtler forms, such as "empire building", consist of mergers and acquisitions that are not value-maximizing, but that serve to aggrandize the power of the CEO.[26] Thus, even assuming that management *could* steer a firm's cash toward profitable investment opportunities, there is no guarantee that it *will*. The rise in a firm's share price after the announcement of a buyback can therefore be explained by shareholders recalculating the probability that the firm's cash is going to be squandered on such suboptimal investments. That cash, once returned to investors, is now free to find its way into a small business loan, a growing firm's shares, a venture capital fund, or a variety of other uses. The much-lamented fact that executive compensation is increasingly tied to share price may in fact be an efficient mechanism by which managers are incentivized to redistribute free cash flow back to

[24] Treece 2011
[25] Jensen and Meckling (1976)
[26] Gompers, Ishii and Metrick (2003); Masulis, Wang and Xie (2007)

shareholders instead of allocating it toward non-profit-maximizing assets.[27]

If buybacks are indeed a tool for management to artificially meet a compensation metric (eg EPS, ROA) the problem lies in the structure of the corporate contract, not with buybacks themselves. Presumably, if managers are incurring large opportunity costs by returning cash that could have gone toward profitable investments,[28] this will *harm* a firm's share price insofar as investors downwardly adjust their expectation that these funds will be used profitably. This line of reasoning merely grants the assumption that shareholders are at least as perceptive as the critics of buybacks, who so confidently claim to know that managers are foregoing high-return investments. But, having granted this assumption, management's ability to "trick" the market via buybacks disappears, because shareholders will penalize the firm's valuation for its unwillingness to undergo profitable investments.

Even allowing for management to systematically and repeatedly manipulate share prices via buybacks to line their own pockets to the detriment of the firm, the logic of natural selection should militate against the persistence of firms with such maladaptive compensation packages. Firms that incentivize their management to sacrifice long-term growth for the sake of juicing EPS will eventually be out-competed in the market by firms that have a more adaptive compensation structure.

Buybacks, moreover, allow firms to nimbly modify their capital structure in response to changing market conditions. As mentioned in Part I Section III, firms have been using share buybacks to rebalance their liabilities away from equity and towards debt partly in response to historically low interest rates, a "great trade" according to Home Depot's CFO.[29] Firms also calibrate their mix of debt and equity financing as a function of expected *future* rates of

[27] Grossman and Hart 1982; Jensen 1986, 1989; Hart and Moore 1995; Hansmann 1996
[28] Palladino (2018)
[29] Ma (2016)

the relative costs of capital. In raising the cost of reversing a round of equity issuance, restrictions on buybacks make forecasting errors much more painful.

One particularly ironic use toward which share buybacks might be deployed is as a defense against shareholder underpricing of a firm's value.[30] If shareholders are systematically mispricing a firm's shares relative to its fundamentals, perhaps by underestimating or overly discounting future growth, management can send a costly signal of its belief that the shares are undervalued by repurchasing and then reissuing them in the future for a capital gain.

If buybacks were indeed a manifestation of stock market short-termism, we would expect them to be most prevalent in economies characterized by diffuse and unconcentrated equities markets, of which the United States is the paradigmatic example. But a 2017 Federal Reserve survey of buybacks finds not only no evidence of a crowding out effect of buybacks on capital investment, but that the rise in gross buybacks is an OECD-wide phenomenon.[31]

3.2 Corporate Governance Reforms

Another set of legal remedies proposed to address the problem of stock market short-termism involves regulating corporate governance and the market for corporate control. In this portion of my analysis, I will focus on two specific subsets of such proposals: 1) reforms mandating a quota for employee (or other "stakeholder") representation on a firm's board of directors, and 2) mandatory provisions for corporate charters that would fortify the board of directors against shareholders, including hostile takeovers by activist investors.

[30] Stein 1996

[31] Gruber and Kamin (2017)

3.2.1 Co-Determination and Elizabeth Warren

On August 15, 2018, Senator Elizabeth Warren formally introduced her "Accountable Capitalism Act", that would, *inter alia*, require of all firms generating $1 billion or more in revenue that "no fewer than 40% of its directors are selected by the corporation's employees." In mandating that corporations include employees qua stakeholders in the firm's major decisions, government would be putting its thumb on the scale in shifting the balance of power away from the corporate governance outcome that has emerged in the free-market: shareholders today exclusively determine the composition of the board of directors. Moreover, progressive politicians and academics would be putting a thumb in the eye of their long-standing bete-noir, the "shareholder value paradigm".

Employee representation on the board is known as "co-determination", part of a larger constellation of corporate governance institutions that comprise the "Rhenish model" of capitalism. Its primary exemplar, Germany, is trumpeted as the prepossessing poster child of this alternative to shareholder *über alles* "Anglo-capitalism". In her press release, Senator Warren makes this inspiration explicit, claiming that she is "borrowing from the successful approach in Germany and other developed economies". Germany's co-determination is praised by its progressive proponents not just for its greater "economic justice", but because it has "held back the forces of short-termism". In a policy brief for the Roosevelt Institute titled "Fighting Short-Termism with Worker Power", economist Susan Holmberg argues that co-determination will create "resilience against the pressures of short-termism". Senator Warren penned an op-ed in the Wall St. Journal to accompany her formal press release, in which she argued that her bill would be a corrective against corporate executives being overly focused on "producing short-term share-price increases".

How, exactly, would greater employee influence over corporate governance

combat short-termism? Proponents argue that employee representatives would prevent both exorbitant CEO pay and excessive share buybacks. Because the typical employee has a longer tenure at the firm than the typical shareholder, employees are therefore better custodians of the firm's revenues, with an eye toward long-term viability, not the maximization of the next earnings report.

The first of many red flags that appears as we proceed along this train of reasoning is that the Germanic model did not evolve organically as the result of firms realizing that increasing employee representation was in their own self-interest. As Holmberg herself notes, the 1976 Employee Co-Determination Act and related legislation *impose* this corporate governance paradigm on German firms, requiring that 50% of the supervisory board represent employees rather than shareholders. Conversely, in the United States, it remains perfectly legal for a firm to so structure its charter. The fact that few firms avail themselves of this eminently superior option should give one pause. The fact that German capitalism is so-characterized speaks less to the economic merits of co-determination and more to the political adroitness of its advocates.

When considering the likely effects Warren's plan would have on U.S. firms, the lessons of the U.S. experience with unions will be instructive. In fact, it's hard not to view mandatory employee board representation as a rearguard action by a labor movement that has seen private sector union membership decline from a post-war high of 34% in 1954 to just under 7% today.[32] In many respects, employee board quotas are the functional analogue of a union granted a legal monopoly to represent the employees of a given firm. While board quotas may be more efficient than unions insofar as they avoid the bargaining costs associated with bilateral monopoly, they nonetheless serve to tilt the balance-of-power over major firm decisions toward employee interests.

The first devil lurking in the details of Warren's plan is: who counts as an

[32] Bureau of Labor Statistics, Union Members Summary

employee for the purposes of allocating director votes? All employees, including management below the C-suite? Or only non-managerial employees? However the definition is generated (and gerrymandered), an insuperable problem arises, one that similarly confronted unions. A firm's employees do not have homogenous preferences. More senior employees on the brink of retirement have a different time-horizon than do younger employees. Employees who intend to snag a few years of experience before moving to another firm or another industry differ from employees who are dreaming of a company watch on their 20th anniversary. These varying constituencies will have starkly different preferences as to how the firm's free cash flow is allocated: higher wages now, more long-term capital investment that will pay off in decades, or shoring up the solvency of the employee pension plan? Similarly, skilled employees will be far less averse to R&D that leads to technology - complimentary to their human capital - than will the unskilled employees with whom it competes. Thus, the category error baked into co-determination is the conceptualization of "employees" as an undifferentiated bloc. Whoever the median employee voter places on the board will inevitably take actions that result in *intra*-employee redistribution.

When considering the preferences that employees broadly do share, it is naïve to think that they will always redound to the long-term benefit of the firm. First, employees of all shapes and sizes uniformly prefer that less cash flow be allocated to share buybacks and dividends. Indeed, champions of co-determination celebrate the extent to which it will serve as a brake on such equity outlays. But, again, we must keep in mind the fallacy of composition: when all firms reduce outlays, the cost of capital for firms with profitable investment opportunities rises and these firms are then unable to grow (read: hire new workers) as quickly.

Moreover, employees won't necessarily want to reinvest earnings into long-

term investments like CAPEX and R&D. And forget returning this surplus to the consumer in the form of lower prices. Instead, they will be inclined to leverage their legislatively-conferred bargaining power to divert profits into wages and benefits *in excess of the marginal product of their labor*. Despite the romance and sloganeering, this is as much an instance of rent-seeking as corporate Ferraris and "excessive" stock buybacks. On top of higher compensation in the present, employee representatives will attempt to commit a greater percentage of the firm's *future* cashflow into retirement and pension plans, rather than R&D projects with an uncertain future payoff that will anyhow make half of them redundant. Employee representatives will have an interest in other measures that similarly reduce the long-term flexibility of the firm.

Other than pre-committing future cashflows to non-productive investments such as pension plans, employees will also prefer greater job security. In raising the costs of replacing an unproductive worker, they are thereby raising the ex-ante costs of hiring generally. Greater employee protections mean that the firm faces higher costs when restructuring the skillset and human capital composition of its workforce to meet the always-evolving market landscape. The relative prices of the highly heterogenous labor pool are constantly in flux, and firms must be able to nimbly rebalance their personnel to adapt and stay competitive. Moreover, overly rigid job protection reduces a firm's ability to temporarily downsize its workforce in response to exigent circumstances. Co-determination advocates might claim that buybacks, dividends, and executive bonuses should be jettisoned before employees when times get tough. But the fact of the matter remains: reducing the degrees of freedom by which a firm might respond to a given short-term adversity compromises its long-term viability. Employee representatives on the board are trading economic efficiency and adaptability for the sake of incumbent employees today. But who can blame them. They are

merely responding to their constituency.

These ossifying effects are not armchair speculation. Far from sagely stewarding tax revenues for the benefit of posterity, public sector unions have managed to rack up $4.4 trillion in unfunded liabilities, darkening the long-run fiscal outlook for many states and municipalities. The much-lamented decline in manufacturing employment in the U.S. is a story first of firms escaping the unionized Midwest to the South, and then the radical restructuring and downsizing of a less protected workforce to a small coterie of highly skilled employees intensively utilizing technology. This explains why U.S. manufacturing output has risen over the past several decades despite the precipitous drop-off in employment: to the immense benefit of U.S consumers. This process would have been seriously stymied if employees were dealt an artificially strong hand at the table via legislative fiat.

Building on a considerable theoretical literature that predicts greater employee bargaining power will reduce research into RD and other productivity-enhancing investments,[33] subsequent meta-analyses of the empirical effects of unions confirm that they are associated with lower productivity growth, lower profits, and lower stock market valuations.[34] It's worth noting that, particularly since 1980, Western European total factor productivity (TFP) growth has dramatically lagged behind that of the United States.[35] Insofar as unions do correlate with productivity increases, the mechanism appears to be via increased communication between workers and management. This is a goal that any half-competent management will attempt voluntarily, but that is impeded by Section 8(a)(2) of the National Labor Relation Act's prohibition on employer-sponsored unions.

[33] Baldwin (1983); Grout (1984); Connollay, Hirsch, and Hirschey (1986)

[34] Doucouliagos and Laroche (2003, 2005)

[35] Fernandez-Villaverde and Ohanian (2018))

3.2.2 Corporate Charter Mandates

In addition to compositional requirements for the board of directors, many short-term alarmists advocate for mandatory corporate charter provisions that would strengthen the board in its relationship vis-à-vis shareholders. If insulated against removal by shareholders, directors may then allow management to pursue the long-term interests of the firm without constantly looking over their shoulder for the ever-present threat of a takeover attempt.

Noted corporate governance scholar Lucian Bebchuk has been intellectually embattled with short-termism alarmists throughout his career. In a 2015 paper casting severe doubt on the alleged long-term harms imposed by activist investors, he and coauthors rehearse the litany of solutions, proposed by prominent academics, judges and elected politicians, to deal with impatient shareholders tempted by activist investors:

> Invoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of activist shareholders. In particular, such arguments have been used to support, for example, allocating power to directors rather than shareholders, using board classification to insulate directors from shareholders, impeding shareholders' ability to replace directors, limiting the rights of shareholders with short holding periods, tightening the rules governing the disclosure of stock accumulations by hedge fund activists, and corporate boards' taking on an adversarial approach toward activists.

Such measures are often explicitly justified with the short-termism thesis:

> ...activists with a short investment horizon have an incentive to seek actions that would increase short-term prices at the expense of long-term performance, such as excessively reducing long-term investments or the funds available for such investments.

How would such reforms help to ameliorate this problem? A specific plan to mandate that director elections occur no more frequently than every five years, advanced by Martin Lipton and Steve Rosenblum, prominent academic subscribers to the short-termism thesis (whose argument was endorsed by Delaware Supreme Court justice Jack Jacobs), exemplifies the animating logic of such re-

forms. They claim that this proposal would address short-termism because it would:

> [P]ermit the delegation of control of the corporation to its managers for sufficiently long periods of time to allow them to make the decisions necessary for the long-term health of their corporation.[36]

First, a rejoinder that may be applied both to this proposal and to similar mandates concerning corporate charter provisions: if clever academics can see how such board entrenchment can be beneficial to a firm's long-term value, why wouldn't all firms *voluntarily* adopt infrequent, staggered elections and other such measures? Long-term-oriented shareholders would then preferentially invest in such firms. Many shareholders would appreciate this Odyssian commitment mechanism that binds them to the mast and prevents them from succumbing to myopic temptation.

Over the long-run, firms that adopt such measures would outcompete firms that do not. Indeed, to the extent that many firms do insulate their boards in some fashion, it is to reap these very benefits. But to impose a minimum insulative threshold on all firms imposes deadweight costs on firms with more acute agency problems, whose shareholders and managers would have otherwise agreed to less board protections. It is in fact the case that, even among long-term investors such as pension funds (e.g. CalPER's and TIAA-CREF) there has been a shift in voting guidelines away from insulated boards.[37] As Bebchuk puts it, "[insulation advocates] should be reluctant to assert that they know the long-term interests of long-term investors better than the investors themselves".

Moreover, as noted in the previous section, it is well and good to suggest that management *might* act in a long-term fashion if made less accountable to shareholders in this way, but this same institutional reform similarly invites managerial rent-seeking. Let's directly assess the evidence that such insulative

[36] Lipton Rosenblum, Quinquennial Election, cited in Bebchuk (2013)
[37] Bebchuk (2013)

provisions generate long-term corporate value, net of the managerial misbehavior that they enable. Again, Lucian Bebchuk has done yeoman's work in undermining this proposition. His 2004 book written with Jesse Fried adumbrates the ways in which a board of directors, when made less accountable to shareholders, is likely to be compromised by a management seeking compensation well in excess of its marginal product of labor. A 2009 article by Bebchuk and coauthors finds a robust negative correlation, both cross-sectionally between firms and over time within a given firm, between an "entrenchment index"[38] of board insulation provisions in a corporation's charter and that corporation's value as measured by Tobin's Q (note that Tobin's Q is not a perfect metric of firm performance, see Dybvig 2012 for criticisms), a finding corroborated both by prior work and many subsequent empirical studies measuring the effects of staggered boards, poison pills, and golden parachutes.[39]

Above and beyond fortifying the board – and, thereby, management – against a firm's existing shareholders who may be braying impatiently for short-term returns, such charter provisions are also encouraged as a prophylactic against a hostile takeover by activist investors. Defensive measures such as staggered boards and poison pills are supplemented by a variety of statutory and regulatory frictions (e.g. onerous SEC 13D disclosure requirements) that serve to raise the costs of a takeover attempt by an activist, and thereby make the market for corporate control less liquid.

The role of such activists has long been controversial in the corporate governance literature, with opponents likening them to vultures or, as Darius Palia and John Coffee title their book: *The Wolf at the Door: The Impact of Hedge*

[38]Bebchuk, Cohen and Ferrell (2009): [The index consists of] four constitutional provisions that prevent a majority of shareholders from having their way (staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, and supermajority requirements for charter amendments), and two takeover readiness provisions that boards put in place to be ready for a hostile takeover (poison pills and golden parachutes).

[39]Bebchuk (2005), Bebchuk, Cohen and Wang (2011), Bebchuk, Cohen and Wang (2014)

Fund Activism on Corporate Governance. But criticism of activist investors has not been confined to the cloistered halls of academe. Delaware Supreme Court Justice Leo Strine's *Who Bleeds When the Wolves Bite?* provides a parallel attack. Then-candidate Hillary Clinton, during the 2015 Democratic primary race, bemoaned the influence of "hit and run" activist investors (she also called for greater disclosure requirements for share buybacks).[40] This broader debate intersects with our discussion of short-termism because critics accuse activists of merely seeking to "pump-and-dump" their targets: acquire a controlling stake in a firm, extract its cash holdings, liquidate any long-term investments, reap the resulting higher share price and then exit before the destruction wreaked to its fundamentals makes itself manifest.

Frightening as these images of predatory animals are, we must also consider the importance of the activist investor's niche in the financial ecosystem. In identifying firms with underutilized or misallocated assets, the threat of an activist campaign is a wake-up call to a somnolent management and a vital safeguard against an extractive management. Considering the theoretical role that activists play in the market for corporate control, we would expect the empirical evidence to demonstrate not only that anti-takeover measures correlate negatively with firm performance (as noted above), but that observed activist activity correlates positively with firm performance.

Indeed, the balance of the literature strongly suggests net positive effects on firm share price, both in the short term and in the long term. A comprehensive study of all attempts at activist takeovers in closed-end funds (CEFs) between 1988 and 2003 found that firms with highly discounted market values were disproportionately targeted by activists, that this discount shrank in the aftermath of a takeover attempt, and that the reason for this market discount

[40] https://www.reuters.com/article/usa-election-clinton/update-5-clinton-proposes-tax-buyback-changes-to-encourage-long-term-growth-idUSL1N10413B20150724

was at least in part attributable to the agency costs suffered vis-à-vis the firm's management.[41]

Two exhaustive literature reviews on activist investors and their effects by Alon Brav and coauthors find that:

> The abnormal return around the announcement of activism is approximately 7%, with no reversal during the subsequent year. Target firms experience increases in payout, operating performance, and higher CEO turnover after activism.
>
> The evidence generally supports the view that hedge fund activism creates value for shareholders by effectively influencing the governance, capital structure decisions, and operating performance of target firms.

In a more recent study, contra such claims that activists seek to "pump-and-dump" a target firm by extracting short-term profits at the expense of long-term profits, Bebchuk, Brav and Jiang adduce the following after examining the full universe of SEC Section 13D filings in the years 2001-2006:

> We find no evidence that activist interventions, including the investment-limiting and adversarial interventions that are most resisted and criticized, are followed by short-term gains in performance that come at the expense of long-term performance. We also find no evidence that the initial positive stock-price spike accompanying activist interventions tends to be followed by negative abnormal returns in the long term; to the contrary, the evidence is consistent with the initial spike reflecting correctly the intervention's long-term consequences.[42]

Ronald Gilson and Jeffrey Gordon, in a paper discussing the institutional synergies between activist investors and index funds that increases the quality of corporate governance, review other parts of this literature that indicate a positive post-takeover effect:

> There is a growing empirical literature that documents the impact of activist shareholder efforts on target company stock prices. Gantchev reports average (median) "raw" shareholder returns of approximately 39% (33%) over the average nineteen-month campaign period and average (median) annualized market-adjusted returns of approximately 4% (4%) Brav et al. report average (median) raw target shareholder returns of 42% (18%) over the campaign period and annualized average (median) market adjusted returns of 21% (4%). Klein and Zur report average target

[41] Bradley et al (2010)

[42] Bebchuk, Brav and Jiang (2015)

shareholder market-adjusted returns of approximately 22% over a one-year post-initiation period.[43]

4 Works Cited

- Section in progress

[43] Gilson and Gordon (2013)