

The Academic-Industry Research Network

# The Burger Buyback King: McDonald's Stock-Price Manipulation Makes Most Americans Worse Off

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## **The Burger Buyback King: McDonald's Stock-Price Manipulation Makes Most Americans Worse Off**

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### Abstract

Millions of low-paid U.S. service workers receive wages of under \$10 per hour, or less than \$20,000 for a full year's work. Focusing on McDonald's, we argue that the company's recent "turnaround plan" all but sacrifices the interests of both its workers and its franchisees, notwithstanding an historical commitment to them as stakeholders in the McDonald's "system," to the interests of speculative shareholders. Ostensibly aimed to counteract a decline in market share that the company has suffered in recent years, this plan is, in fact, primarily designed to effect manipulative boosts to the price McDonald's shares and thereby to increase the amount of corporate cash distributed to shareholders. For the decade 2005-2014, McDonald's expended \$29.4 billion on stock buybacks, representing 67 percent of net income, and \$22.1 billion on dividends, equivalent to another 51 percent of net income. Over this period, the company also increased its debt outstanding by an amount covering about 11 percent of its shareholder distributions. While long-term shareholders that seek dividend income are currently well rewarded by McDonald's, they too may eventually be on the losing end as the company's distributions lead to further weakening of its competitive position. McDonald's pursuit of buybacks -- like that of other large, often iconic U.S. businesses -- is contributing to a process that concentrates income among the country's richest households while eating away at the incomes of virtually everyone else. In the conclusion to this report we argue that if the American people are to have their own "turnaround plan," the U.S. Congress must ban manipulative stock buybacks, restructure executive pay, and reform corporate governance by changing representation on corporate boards.

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<sup>1</sup> The views expressed in this report are solely those of the three co-authors. The report was developed with support from the Service Employees International Union. The most recent research that underpins the views expressed in the report derives from academic projects led by William Lazonick with grants from the Ford Foundation and the Institute for New Economic Thinking.

## McDonald's: Flipping Burgers for Buybacks

As a central plank of its “turnaround plan,” announced on May 4, 2015, McDonald's Corporation committed to “return \$8 to \$9 billion to shareholders in 2015 and to reach the top end of its 3-year[,] \$18 to \$20 billion cash return to shareholders target by the end of 2016.”<sup>2</sup> This part of McDonald's plan is much less a “turnaround” than it is an escalation of distributions of corporate cash to shareholders, an activity that over the past decade has become the major focus of its corporate strategy. For the decade 2005-2014, the company expended \$29.4 billion on buybacks, representing 67 percent of net income, and \$22.1 billion on dividends, equivalent to 51 percent of net income. Over this period, the company increased its debt outstanding by an amount that covered about 11 percent of its distributions to shareholders. In 2014 alone McDonald's paid out a record \$3.2 billion in dividends, which it complemented with almost the same amount in buybacks, so that these distributions to shareholders totaled 134 percent of net income.

Figure 1 tracks McDonald's distributions to shareholders from 1979, when buybacks were very small. As can be seen, the company ramped up its buyback activity during the Internet boom of the late 1990s and then again amid the frenzy of general financial speculation and manipulation in the years preceding the Great Financial Crisis of late 2008 and 2009. As was the case with other major stock repurchasers in the United States,<sup>3</sup> McDonald's did most of its repurchases when its stock price was high (see Figure 1).

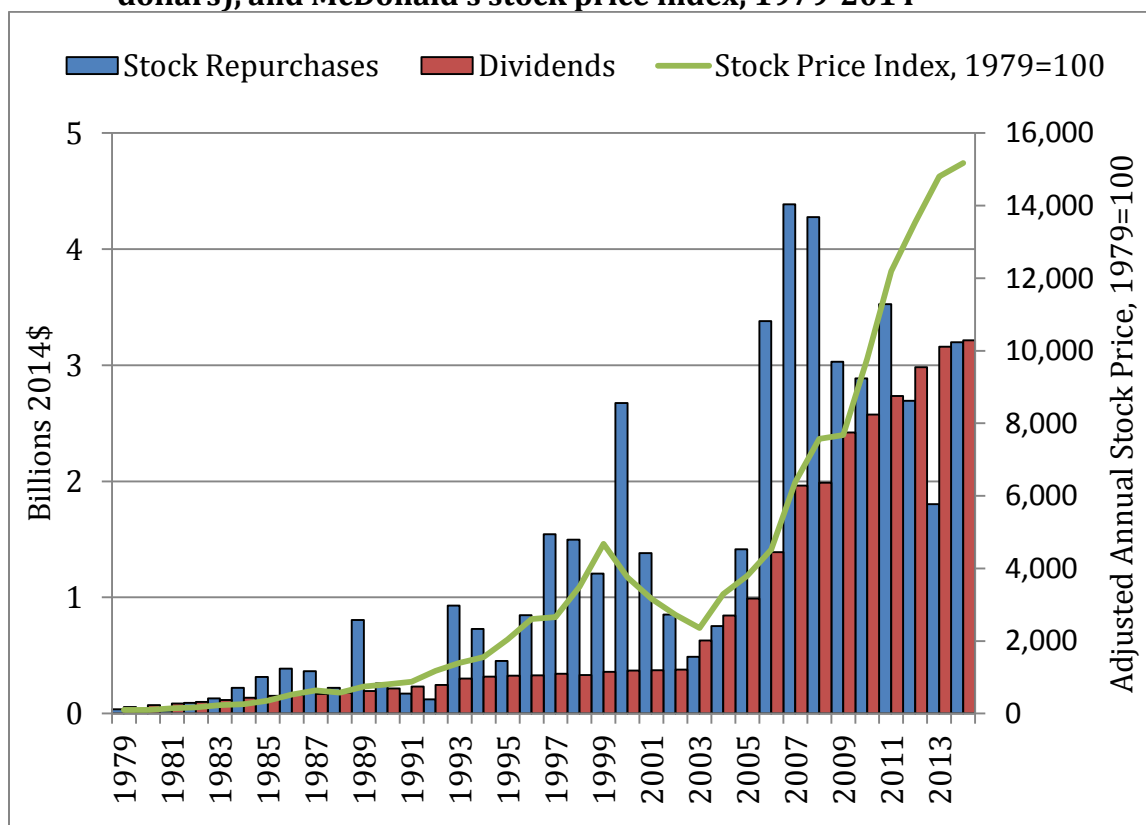
Figure 1 gives the lie to any notion that McDonald's buys back its stock because it is undervalued and hence represents a good investment for the company. This oft-heard argument in defense of buybacks is clearly hollow: Once a CEO or CFO makes this claim, he or she cannot *sell* the stock at a higher price for the benefit of the corporate treasury without signaling to stock-market traders that the stock is *overvalued*, something that no top executive would want to do. Rather, it is corporate executives with their ample stock-based compensation who benefit by selling company stock they personally own when stock prices are high. They realize gains by exercising their stock options and through the vesting of their stock awards, the latter generally triggered by the company's hitting quarterly earnings per share (EPS) targets.

The value of stock-based compensation is high. From 2006 through 2014, total CEO pay at McDonald's varied from a low of \$3.6 million in 2013, when realized gains from stock-based pay represented 27 percent of total pay, to a high of \$20.1 million in 2010, when, dominated by the gains from exercising stock options, stock-based compensation accounted for 70 percent of total compensation. For the other four highest-paid McDonald's executives as named in the company's proxy

<sup>2</sup> McDonald's Corporation, “McDonald's announces initial steps in turnaround plan including worldwide business restructuring and financial updates,” McDonald's press release, May 4, 2015, at <http://news.mcdonalds.com/Corporate/news-stories/2013/McDonald-s-Announces-Initial-Steps-In-Turnaround-P>

<sup>3</sup> William Lazonick, “Profits Without Prosperity: Stock Buybacks Manipulate the Market and Leave Most Americans Worse Off,” *Harvard Business Review*, September 2014: 46-55; William Lazonick, “Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute,” Brookings Institution Center for Effective Public Management, April 2015, at <http://www.brookings.edu/research/papers/2015/04/17-stock-buybacks-lazonick>

**Figure 1: McDonald's stock repurchases and dividends (billions of 2014 dollars), and McDonald's stock price index, 1979-2014**



Source: Yahoo! Finance (adjusted annual stock prices based on monthly averages); Company 10-Ks.

statements, average total compensation ranged from a low of \$1.5 million in 2014 to a high of \$12.6 million in 2012, with the proportion of these totals derived from gains from stock-based compensation ranging from 37 percent in 2006 to 77 percent in 2010. The paramount importance of stock-based compensation in determining the size of their pay packages gives these executives a strong incentive to do open-market repurchases, which give manipulative boosts to the company's stock price.

In his 2014 *Harvard Business Review* article "Profits Without Prosperity," Lazonick has shown that (to quote its subtitle) "stock buybacks manipulate the market and leave most Americans worse off."<sup>4</sup> Who gains and who loses from McDonald's allocation of billions of dollars annually to buybacks and dividends? Clearly, McDonald's top executives gain. So too, we argue in this report, do hedge-fund activists, who started targeting McDonald's a decade ago,<sup>5</sup> and Wall Street investment banks, which seek to time their stock purchases and stock sales to take advantage of price boosts that result from the company's stock buybacks.

<sup>4</sup> William Lazonick, "Profits Without Prosperity" *Harvard Business Review*, September 2014, at <https://hbr.org/2014/09/profits-without-prosperity>

<sup>5</sup> See Dave Carpenter, "Vornado buys stake in McDonald's, renewing spinoff speculation," *Associated Press Newswires*, November 1, 2005; Dave Carpenter, "McDonald's raises dividend 49 percent, shares hit 6-year high," *Associated Press Newswires*, September 27, 2006; Dave Carpenter, "Investor Proposes Shake-up at McDonald's," *Associated Press Newswires*, November 15, 2005.

In the sections that follow we explain how stock buybacks manipulate the stock market and why McDonald's stable (often called "long-term" or "continuing") shareholders, such as pension funds, lose out along with franchisees and employees. McDonald's stock buybacks are contributing to a process that concentrates income among the very richest U.S. households – top corporate executives, hedge-fund managers and Wall Street bankers among them – while eroding the incomes of virtually everyone else. In the conclusion to this report we argue that if the American people are to have their own "turnaround plan," the U.S. Congress must ban manipulative stock buybacks, restructure executive pay, and reform corporate governance by changing representation on corporate boards.

### **How stock buybacks manipulate the market**

The role of business enterprises in the economy is to produce goods and services that households, other businesses, or government agencies need or want to buy at prices that they are able or willing to pay. Yet, since the mid-1980s, a major activity of business corporations in the United States has been the repurchase of their own companies' shares on the stock market. Contrary to the myth that stock markets provide investment finance to business corporations, over the past three decades it has been business corporations that have fueled the stock market with massive share repurchases, done with the aim of driving up the prices of their shares.

For U.S. non-financial corporations over the decade 2005-2014, net equity issues – that is, the value of new stock issues less the value of shares taken off the market by repurchases and merger-and-acquisition (M&A) activity – averaged *minus \$399 billion per year*. Those who gain from repurchases, or "buybacks" as they are more popularly known, are those who sell their shares. These sellers call it "unlocking shareholder value," as if the corporate cash that is distributed through buybacks belongs to them. But people who buy outstanding shares on the stock exchange do not invest in the productive capabilities of the company that originally issued those shares. Rather, they seek to obtain income either, as *shareholders*, through the payment of dividends, or, as *sharesellers*, by reselling their shares on the stock market for prices higher than those they paid to buy them.

Shareholders, who as the name says hold shares to get a stream of income from dividends, do not gain from buybacks. Indeed, they are likely to lose from buybacks because of the diminished cash reserves out of which the company can pay dividends now and in the future. The winners in the "buyback economy" are the speculative sharesellers who can time the market to reap stock-price gains. The losers in the "buyback economy" have been American households who, as shareholders, taxpayers and workers, have been precluded from harvesting much of the value that their investments of money and effort have produced.

Large corporations such as McDonald's – which was the 30<sup>th</sup>-largest share repurchaser in the United States in the decade 2004-2013 – do the bulk of the buybacks in the U.S. economy. Over the past decade U.S. corporations included in the S&P 500 Index have expended almost \$4 trillion on stock repurchases, representing more than 50 percent of their net income. These buybacks are on top of almost \$3 trillion in dividends that these companies have distributed to shareholders,

absorbing an additional 35 percent of net income. Major U.S. corporations keep much of the remaining net income abroad, exploiting a tax rule dating back to 1960 that enables them to defer payment of U.S. corporate taxes until they repatriate the profits.<sup>6</sup> Historically low interest rates for the last several years have made it possible for companies to opportunistically finance their distributions to shareholders with inexpensive debt.<sup>7</sup> It is not unusual for a company to spend well in excess of 100 percent of net income on distributions to shareholders in the form of repurchases and dividends.

How can a stock buyback manipulate the market? The answer to this question requires an understanding of how the vast majority of buybacks are done, and most often they are done in the form of open-market purchases. First, a company announces that its board of directors has approved a buyback *program*; for example, in May 2014 McDonald's announced that its board had authorized a \$10 billion repurchase program with no expiration date, replacing a similar program announced in July 2010. Many financial economists have shown that stock prices rise after such an announcement, even before any repurchases have actually been made.

Armed with this authorization, the company's CEO and CFO can decide to do, say, \$150 million in stock buybacks on any given day; and when these purchases are executed, all other things being equal, the added demand they create will in itself cause the stock price to rise. Stock-market traders are likely to notice this rise in the company's stock price and bid the stock price even higher. The company may continue to do buybacks over several days to keep the momentum going. Although the stock-trading public will know that the company has authorized a buyback program, it will not know if and when the buybacks are actually being done because companies are not required to disclose this information. Of course, the top executives who are party to the decision to do the buybacks will have this information, as will the broker who carries out the repurchase for the company.

When a company repurchases its shares, they become part of treasury stock and are no longer counted as outstanding shares. As a result, again all other things being equal, earnings per share (EPS) will rise from this manipulated reduction of the ratio's denominator. By taking shares off the market, McDonald's buybacks increased EPS by 42 percent over what it would have been in 2014 if no buybacks had been done over the 1997-2014 period (see Figure 2).

Since 2004, a company has been required to disclose in its quarterly financial report (10-Q) the amount of buybacks that it has done during each month of the quarter and the average price that it paid for them. These quarterly reports are available to the public, and stock-market traders take EPS to be the prime indicator of a company's stock-market performance. As a result, with the publication of the 10-Q, yet another round of speculation may follow from the original manipulation.

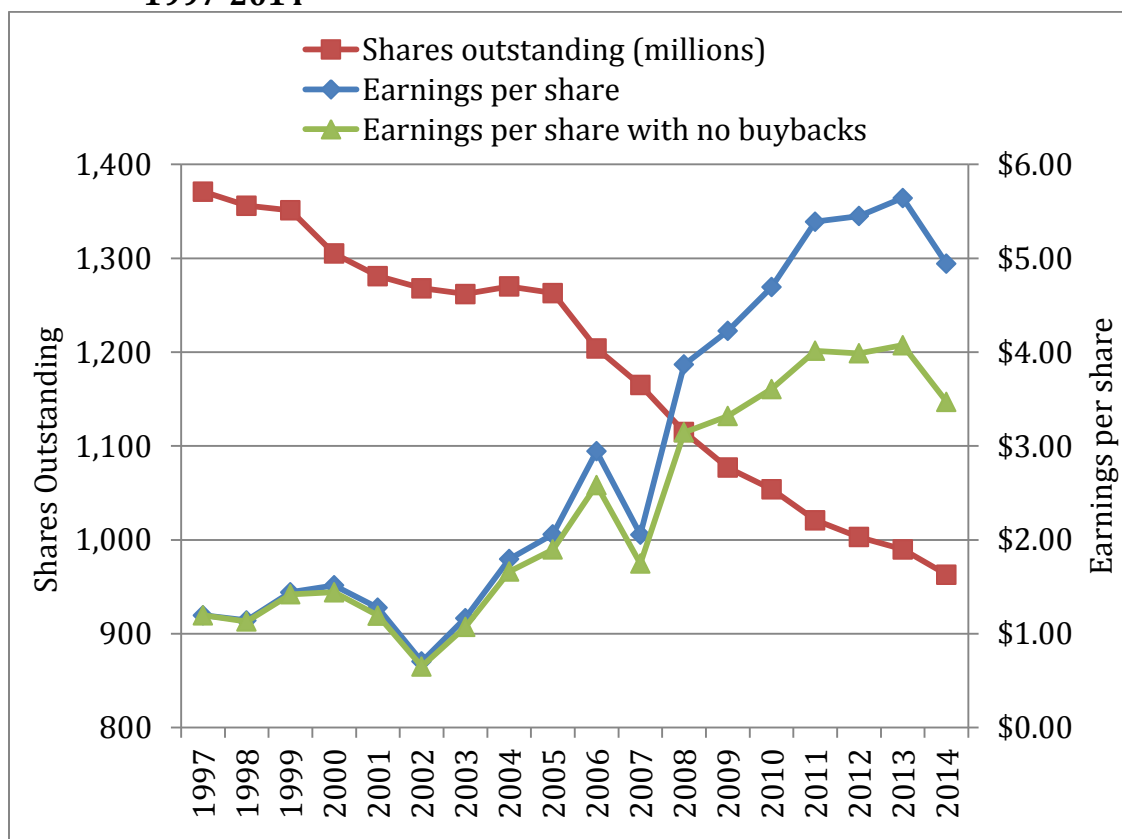
It is generally recognized that "Wall Street" will punish the stock price of companies that fail to attain quarterly EPS targets, and hence well-timed buybacks

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<sup>6</sup> William Lazonick, "The Financialization of the U.S. Corporation: What Has Been Lost and How It Can Be Regained," *Seattle University Law Review*, 36, 2013, pp. 900-903.

<sup>7</sup> For example, James Saft, "When a buyback looks like executive pay," *Reuters*, May 29, 2013, at <http://www.reuters.com/article/2013/05/29/us-buybacks-excep-pay-saft-idUSBRE94S17W20130529>

**Figure 2: McDonald's shares outstanding and earnings per share (EPS), 1997-2014**



Source: McDonald's 10-K filings

are a prime way in which a company can “manage” – i.e., manipulate – EPS so that it does not “surprise the Street.” Given their stock-based compensation, corporate executives are highly incentivized to boost stocks prices, even if only temporarily, through the use of buybacks.

As shown in Table 1, from 2006 through 2013 the total remuneration of the 500 highest-paid executives as named in company proxy statements averaged \$24.4 million in 2013 dollars, ranging from a low of \$14.4 million in 2009 to a high of \$32.2 million in 2013. Of these total amounts, the gains from the exercise of stock options and the vesting of stock awards contributed between 66 percent (in 2009) and 84 percent (in 2013) of total compensation, standing in contrast to salaries and bonuses, which together only accounted for a high of 12 percent (2009) and a low of 5 percent (2013) of total compensation.<sup>8</sup>

A senior executive’s privileged knowledge of the dates on which the company is actually going into the market to execute its stock repurchases can be extremely valuable when it comes to the timing of stock-option exercises. Even under SEC Rule

<sup>8</sup> See William Lazonick, “Taking Stock: Why Executive Pay Results in an Unstable and Inequitable Economy,” Roosevelt Institute White Paper, June 5, 2014, at <http://www.rooseveltinstitute.org/taking-stock-executive-pay>

**Table 1. Mean total direct compensation and the components thereof for the 500 highest-paid executives named in U.S. corporate proxy statements, 2006-2013**

	Mean Total Direct Comp. \$m.	Mean Total Direct Comp. 2013 \$m.	Percentage shares of components of total direct compensation						
			Salary	Bonus	Non-Equity Incentive Plan	All Other Comp	Deferred Earnings	Realized Stock Option Gains	Realized Stock Award Gains
2006	27.4	30.8	3.3	7.0	7.6	5.9	0.5	58.9	16.8
2007	30.0	32.9	3.0	4.1	6.9	7.6	0.1	58.8	19.6
2008	22.9	24.6	4.1	4.2	8.7	4.1	0.1	43.9	34.9
2009	14.4	15.4	7.0	4.8	14.9	7.4	0.1	39.9	25.9
2010	18.5	19.5	5.5	4.8	15.0	6.2	0.1	40.3	28.1
2011	19.4	20.0	5.5	4.8	15.0	6.2	0.1	40.3	28.1
2012	30.3	30.8	3.6	2.7	8.2	3.2	0.1	41.5	40.7
2013	32.2	32.2	3.3	1.9	7.6	3.5	0.1	55.4	28.2

Source: Standard and Poor's ExecuComp database, with calculations by Matt Hopkins, The Academic-Industry Research Network

10b5-1, adopted in 2000 to control such insider trading, top executives can find ways to time their option exercises and stock sales to increase their pay.<sup>9</sup> The vesting of an executive's stock awards is often dependent on whether the company hits quarterly EPS targets, something in which stock buybacks – if carried out, for example, in the final days of the quarter – might well play a role.

To whom do we owe this least level of playing fields? The Securities and Exchange Commission (SEC) gave encouragement to such manipulative buybacks in November 1982, when it adopted its Rule 10b-18 governing open-market share repurchases.<sup>10</sup> Rule 10b-18 promises not to hold a company liable for manipulating the market if it keeps its open-market repurchases within a set of limits – or stays within a “safe harbor,” as the area within the limits is called. Among other things, the value of buybacks on any single day may not exceed 25 percent of the previous four weeks' average daily trading volume (ADTV); none of the buybacks may be executed within certain periods at the beginning and end of a trading day; and all of the repurchases on any given day must be done through one broker only.<sup>11</sup> Companies are not presumed to have engaged in manipulation simply because their repurchases on any day exceed the 25 percent ADTV safe harbor limit; rather, their actions may be reviewed by the SEC on a case-by-case basis.<sup>12</sup> Conversely, those staying within the safe harbor, while sheltered from liability arising from manipulation, are still liable for violations that “may occur in the course of an issuer repurchase program but which do not entail manipulation.”<sup>13</sup> But because the SEC

<sup>9</sup> See, for example, Jesse Eisinger, “Repeated good fortune in timing of CEO's stock sale,” *New York Times Dealbook*, February 19, 2014, at <http://dealbook.nytimes.com/2014/02/19/repeated-good-fortune-in-timing-of-c-e-o-s-stock-sale/>

<sup>10</sup> Securities and Exchange Commission, “Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor,” November 17, 1982, *Federal Register*, Rules and Regulations, 47, 228, November 26, 1982: 53333-53341.

<sup>11</sup> <http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm>

<sup>12</sup> Securities and Exchange Commission, “Purchases of Certain Equity Securities”: “Repurchases outside of the safe harbor that are manipulative, of course, continue to be actionable under the securities laws.” (p. 53337).

<sup>13</sup> Securities and Exchange Commission, “Purchases of Certain Equity Securities”: “...Rule 10b-18 confers no immunity from possible Rule 10b-5 liability where the issuer engages in repurchases while in possession of favorable, material non-public information concerning its securities” (p.53334, fn.5).



does not require that companies disclose their repurchase activity broken down by the days on which buybacks are actually done, it must launch a special investigation if it is even to obtain information upon which it can judge whether the 25 percent ADTV limit has or has not been exceeded.

Rule 10b-18 covers only open-market repurchases, but it is in the open market that undetected stock-price manipulation can most easily occur. Private, off-market transactions such as tender offers are not regulated under the Rule. In 1982 the SEC also excluded “block trades” (trades at or above \$200,000 in value or numbering at least 5,000 shares with a minimum value of \$50,000) from the 25 percent ADTV calculation, apparently because in the early 1980s block trades, although done on the open market, were viewed as exceptional. In a revision of Rule 10b-18 in 2003, however, the SEC included most block trades in the 25 percent ADTV calculation.<sup>14</sup>

The daily buybacks that are permissible within the 25 percent ADTV limit are sufficiently large to enable a company to manipulate its own stock price. Assuming block trades were included in the ADTV calculations under Rule 10b-18, McDonald’s, for example, could have bought back up to \$155 million worth of shares on May 1, 2015 (to take a recent date) without fear of facing manipulation charges. On that date, the daily safe-harbor limits on buybacks by the top 10 repurchasers for 2004-2013 ranged from \$86 million for Hewlett-Packard to \$504 million for Microsoft. Also on May 1, 2015, Apple Inc., which did \$22.9 billion in buybacks in fiscal 2013 and another \$45.0 billion in 2014 – after having largely refrained from the practice during the reign of Steve Jobs – could have done up to \$1.55 billion per day while availing itself of the safe harbor. Rule 10b-18 permits open-market repurchases of these manipulative magnitudes to be repeated trading day after trading day.

### **How stock buybacks make most Americans worse off**

The privileged few who in 1982 were empowered by Rule 10-18 to augment the value of their own stock-based compensation through the use of buybacks were given additional incentive to do so in 1991. Until then, Section 16(b) of the 1934 Securities Exchange Act prevented top executives from reaping short-swing profits when they exercised their stock options by requiring that they wait at least six months before selling the acquired shares. In 1991, the SEC determined that henceforth the six-month waiting period would begin at the grant date, not the exercise date. Since the option grant date is always at least one year before the option exercise date, this reinterpretation of Section 16(b) means that top executives, as company insiders, can sell the shares acquired from stock options immediately upon exercise and keep what would have previously been considered short-swing gains.

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<sup>14</sup> Securities and Exchange Commission, “Purchases of Certain Equity Securities by the Issuer and Others,” (November 10, 2003), *Federal Register*, Rules and Regulations, 68, 221, November 17, 2003: 64952-64976. In response to comments on the proposed amendments to Rule 10b-18 that expressed concern that the elimination of the block exception would have an adverse impact on issuers with moderate or low ADTV that relied mainly on block purchases to implement their repurchase programs, the SEC amendment permitted a company to do one block trade per week that would remain an exception to the 25% ADTV calculation so long as no other repurchases were made on that day.

Who, besides senior executives, gains the most from buybacks? It is powerful Wall Street investment banks and hedge funds that can use their financial might to influence stock prices and are best positioned to time their stock trades. It is not inconceivable that, even without the illegal transmission of inside information, large, sophisticated traders can figure out when a company is doing buybacks. For example, when the SEC adopted Rule 10b-18 in 1982, it stipulated that on any given day all of a company's buybacks must be done through just one broker, lest simultaneous buying by a number of brokers create the appearance of heightened general interest in the company's stock. At that time, as we noted above, the SEC did not see block trades, which are carried out by investment banks, and increasingly since the late 1980s by hedge funds, as a serious issue in the regulation of buybacks. Now that these big Wall Street traders dominate the market, however, the requirement that all repurchases be done through one broker may well help them to spot the days on which a company is actually executing its purchases and, with the benefit of this knowledge, to time their stock trades so as to profit from them.

A stock market driven by manipulation and speculation creates a stock-price bubble that is bound to burst sooner or later, wiping out the gains that ordinary shareholders may have reaped in the boom. In effect, value extraction, not value creation, has sustained this boom. The only way that stock prices can remain higher permanently is if they have a foundation in value creation – that is, in the real productivity growth that comes from developing and utilizing productive resources.

A prime means of value extraction, stock buybacks snatch returns from households that, both as workers and as taxpayers, have contributed to the value-creation process and that, as savers, may seek to secure a financial return by holding outstanding corporate shares to receive a dividend yield. It is this process of redistribution of income from value creators to value extractors that leaves the majority of Americans shortchanged. Buybacks make workers worse off when they come at the expense of employment stability and wage increases. Buybacks make taxpayers worse off when corporations that benefit from government investments in infrastructure and knowledge, as well as all manner of government subsidies, seek to avoid taxes while squandering massive amounts of profits to support continued manipulation of their stock price. Finally, buybacks make stable, or long-term, shareholders worse off when they reduce or jeopardize their dividend yields.

General Motors (GM) is a recent case in point.<sup>15</sup> From the 1970s GM faced intense competition for market share in the automobile industry, yet between 1986 and 2002 its senior executives chose to waste \$20.2 billion buying back the company's stock. Lazonick has calculated that if the company had instead invested this money at a 2.5 percent after-tax annual return, it would have had \$35 billion in its coffers in 2009 to stave off bankruptcy and invest in competitive products.<sup>16</sup> Instead GM had to turn to the U.S. and Canadian governments, as well as the United Auto Workers (UAW) through workers' pension funds, to bail it out after it declared bankruptcy in June 2009.

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<sup>15</sup> See William Lazonick and Matt Hopkins, "GM's Stock Buyback is Bad for America and the Company," *Harvard Business Review Network Blog*, March 11, 2015, at <https://hbr.org/2015/03/gms-stock-buyback-is-bad-for-america-and-the-company>

<sup>16</sup> William Lazonick, "The buyback boondoggle," *BusinessWeek*, August 13, 2009, at [http://www.bloomberg.com/bw/magazine/content/09\\_34/b4144096907029.htm](http://www.bloomberg.com/bw/magazine/content/09_34/b4144096907029.htm)

GM was brought out of bankruptcy in just over a month without any new business-sector financing, but the creation of the “new GM” required concessions from bondholders, workers, dealer networks and other stakeholders. Even GM’s senior executives had to scrape by, for a time, on compensation far below the norm. Those holding stock in the “old GM” ended up among GM’s losers; and, owing to a recent court ruling that the company should remain shielded from liabilities dating to before its bankruptcy, so have the families of those who died as a result of its failure to correct flawed ignition systems in millions of its vehicles.

With taxpayers acting, in effect, as the lender of last resort, GM has been able in recent years to attain some competitive success. But its long-term survival is far from assured, and the costs of the bailout to taxpayers and workers have been high. U.S. taxpayers lost \$11.2 billion on their investment in GM when, in line with the ideology that the government should shed its ownership of the business as soon as possible, the majority stockholding of the U.S. government was sold before taxpayers could fully benefit from GM’s return to profitability. As part of the deal, the UAW accepted wage cuts aimed at generating \$11 billion in labor-cost savings, including a reduced wage for non-core new hires of just \$14 per hour, a low-wage tier that the UAW had begun to accept in 2007 in an attempt to help make U.S. car manufacturers more competitive. In addition, pension and healthcare costs were transferred to a Voluntary Employee Beneficiary Association (VEBA) funded primarily with GM common stock. In an insider account of the bailout, the Obama administration’s lead advisor on the auto-industry crisis, Steven Rattner, makes it no secret that the goal of financing the VEBA with GM stock was to align the interests of GM’s workers with those of its shareholders.<sup>17</sup> Now, to a large extent, the performance and value of GM stock will dictate the ability of the VEBA to continue supporting those it covers.

Since 2010, when its \$23 billion initial public offering was the largest in history up to that time, the “new GM” has been generating profits – and it will need all the financial resources it can muster to produce automobiles that buyers in diverse global markets want at prices that they are willing to pay. Yet a group of hedge funds that bought up 3 percent of GM’s stock took aim at those very resources, hiring as its representative Harry J. Wilson, an architect of the GM bailout as a member of the Obama administration’s Auto taskforce. In March 2015 this group was able to get GM’s board to agree to waste \$5 billion on stock buybacks through December 2016. GM is using massive amounts of corporate cash to manipulate its stock price so that stock-market speculators can sell the company’s stock for their own gain. Taxpayers and workers financed the GM bailout, but now that the company is profitable, powerful hedge-fund activists who played no role whatsoever in GM’s return to profitability are demanding that stock buybacks be instituted so that they may extract the gains for themselves.

### **Stock buybacks and the fight for \$15**

It is a telling fact about the race to the bottom into which members of the U.S. labor force have been pushed that, as protest mounts for a minimum \$15 wage for service workers in business and government, just \$14 per hour has become the base

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<sup>17</sup> Steven Rattner, *Overhaul*, Houghton Mifflin, 2010, p.258.

wage for increasing numbers of unionized manufacturing workers in the U.S. automobile industry. Millions of low-paid service workers receive wages well under \$10 per hour, or \$20,000 for a full year of work, at retailers such as Walmart, Target and Sears, and at fast-food chains such as McDonald's, Yum Brands (Taco Bell, Pizza Hut, KFC) and Burger King.<sup>18</sup> The growing clamor for higher minimum wages raises a powerful question: Can any society the majority of whose citizens endures such a low standard of living be considered a model for others to follow? The answer to this political question depends on the answer to an economic question: Does the United States have the productive capability to pay millions of low-wage workers a substantially higher wage?

Among economists, this latter question has been confronted in analyses that seek to identify the possible sources of pay increases that could enable these millions of service-sector workers to earn something approaching a "living wage." In a recent paper on the economic possibilities for a \$15 minimum wage, Robert Pollin and Jeannette Wicks-Lim argue that if the minimum wage had kept pace with inflation and productivity since 1968, it would currently stand at \$25.50 per hour.<sup>19</sup> They then identify four ways other than through layoffs whereby raises for low-wage workers can be paid for by the economy:

- **Augmented worker productivity:** By creating positive incentives, higher wages could partially pay for themselves as they reduce turnover and boost the quality and quantity of work effort that employees exert.
- **Product price increases:** Depending on the price elasticity of demand for its products, an employer may be able to pay for a wage increase by charging customers higher prices for the products that it sells.
- **Increased revenues from growth:** As a company sees its revenues grow in an expansive economy, it will possess a larger pool of profits, some of which could be used to pay workers higher wages.
- **Redistribution of the firm's profits:** Even with a given profit pool, the company could allocate some its profits to higher wages, accepting either a lower profit margin or, possibly, motivating managers to increase the quality and quantity of their own work effort in finding new sources of cost efficiency.

The first two potential sources of higher wages (productivity and price increases), while clearly possibilities, still need to be analyzed in specific contexts. In the service sector, Costco and Market Basket are well-known examples of companies that pay their workers higher wages than their competitors and secure higher worker productivity as a result.<sup>20</sup> Wicks-Lim and Pollin have done an

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<sup>18</sup> Walter Hickey, "The 20 companies with the most low-wage workers," *Business Insider*, February 13, 2013, at <http://www.businessinsider.com/the-20-companies-with-the-most-low-wage-workers-2013-2>.

<sup>19</sup> Robert Pollin and Jeannette Wicks-Lim, "A \$15 U.S. Minimum Wage: How the Fast-Food Industry Could Adjust Without Shedding Jobs," *Political Economy Research Institute*, University of Massachusetts Amherst, January 2015, p. 2, at [http://www.peri.umass.edu/fileadmin/pdf/working\\_papers/working\\_papers\\_351-400/WP373.pdf](http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_351-400/WP373.pdf)

<sup>20</sup> See Wayne F. Cascio, "The High Cost of Low Wages," *Harvard Business Review*, December 2006; Thomas Kochan, "Lessons learned: What the Market Basket protest offers workers and managers," MIT Sloan School, September 17, 2014, at <https://mitsloan.mit.edu/newsroom/2014-market-basket.php>

analysis that shows that a 2.7 percent increase in the prices that customers pay for products could fund an increase in the minimum wages at U.S. fast-food restaurants from their actual 2013 levels to \$10.50 per hour.<sup>21</sup> But while suggesting that profits from hypothetical sources be reallocated to wages, as they do in their latter two points, Wicks-Lim and Pollin entirely pass over an enormous source of profits that already exists: the huge sums currently spent by corporations like McDonald's on buybacks.

So let us now return to McDonald's, well known as the world's largest fast-food chain with its 36,200 retail outlets in 119 countries, of which 6,700 are owned by McDonald's Corporation and the rest are franchised. In the United States, where there are about 12,500 McDonald's restaurants with 840,000 employees, the Corporation owns 1,500 stores that employ 90,000. The average hourly wage of McDonald's employees is about \$9.00. Recently, McDonald's announced that it would increase the wages of the 90,000 workers in the stores that it owns to one dollar per hour over the legal minimum wage, bringing the average wage of these employees to \$9.90 per hour.<sup>22</sup>

The fact is that, at McDonald's, shareholders who want to secure an income by, as the name says, *holding* the company's stock already do quite well through the company's generous dividend payouts. A detailed analysis of McDonald's business model stated that while McDonald's "has a higher free cash flow yield than its peers, at 4.32%...[i]t also has a much higher dividend yield of 3.23%, making it part of an elite group of Dow and S&P 500 companies in the United States called the 'dividend aristocrats'."<sup>23</sup> Indeed, those institutions or individuals that buy McDonald's shares for the sake of its dividend yield *should be in opposition to stock buybacks*, which benefit only those who want to time the market by selling the stock during the relatively brief windows in which manipulative buyback activity combines with speculative after-effects to create the opportunity for extracting a large trading gain. For *shareholders*, as distinct from *sharesellers*, the reallocation of buybacks to invest in the value-creating capabilities of the company would provide a much rosier prospect for a continuation of high-yield dividend payouts. Indeed, long-term shareholders may realize that, quite apart from buybacks, even current dividend payouts can be too high to permit the allocation of profits to reinvestment in the productive capabilities of the company at a level that will permit a persistent and consistent stream of dividend income over the longer run.

Over the past decade, McDonald's has spent an annual average of \$2.95 billion on buybacks. If McDonald's were to stop doing stock buybacks, who, besides real, i.e., long-term, shareholders, would be possible beneficiaries? We can frame the answer in terms of the metaphor, first articulated by McDonald's founder Ray Kroc in 1955, of McDonald's as a "three-legged stool" in which the corporate "seat" is supported by balanced contributions to company success from the "legs":

<sup>21</sup> Jeannette Wicks-Lim and Robert Pollin, "The Costs to Fast-Food Restaurants of a Minimum Wage Increase to \$10.50 Per Hour," *PERI Research Brief*, University of Massachusetts Amherst, September 2013, at <http://www.peri.umass.edu/236/hash/75171d3ec73a8a0b519e706123814442/publication/585/>

<sup>22</sup> Stephanie Strom, "McDonald's to raise pay at outlets it operates," *New York Times*, April 1, 2015, at [http://www.nytimes.com/2015/04/02/business/mcdonalds-raising-pay-for-employees.html?\\_r=0](http://www.nytimes.com/2015/04/02/business/mcdonalds-raising-pay-for-employees.html?_r=0)

<sup>23</sup> Samantha Nielsen, "McDonald's global business model, the 'three-legged stool'," *Market Realist*, December 25, 2013, at <https://marketrealist.com/2013/12/mcdonalds-global-business-model-three-legged-stool/>

franchisees, suppliers and employees.<sup>24</sup> “The stool,” says McDonald’s in Kroc’s online biography, “was only as strong as the three legs that formed its foundation.”<sup>25</sup>

In building McDonald’s into the world’s largest fast-food chain, Kroc, who led the company for almost three decades until his death in 1984, was a pioneer in making the franchise a potentially lucrative business opportunity for the small investor, who would actively manage his or her family enterprise. By keeping royalties to the corporation low, Kroc left more profits with the franchisee, while the corporation made most of its own profits -- and also exercised control over franchisees -- by owning the land and buildings where the restaurants were located and charging the franchisee rent. Kroc developed relations with a relatively small but stable group of suppliers whose efficiencies in mass production and distribution were to some extent passed on to the franchisees. And, for employees, the early McDonald’s business model tapped into a low-wage teenage labor force of baby boomers who worked part-time at its restaurants on the way, hopefully, to bigger and better things.<sup>26</sup>

From the 1980s, McDonald’s became increasingly financialized, with those who ran the corporation more concerned about increasing stock prices than creating competitive products. The strong and stable group of suppliers remained, but the small and fragmented franchisees found that the company had become far less interested in a shared prosperity. Meanwhile, the ranks of McDonald’s labor force, historically composed of teenagers working part time, were increasingly filled by adults seeking full-time work and trying to support themselves and their families on poverty-level wages.<sup>27</sup> If, by virtue of its legacy of market dominance, McDonald’s three-legged stool remains upright, it does so only because two legs – the franchisees and the employees – have to produce more and earn less if they want to make a living at all. To sustain steady outflows of dividends and buybacks well in excess of 100 percent of profits, the corporation squeezes franchisees, who in turn try to squeeze their low-wage workers in order to remain profitable.

Increasingly, franchisees of fast-food companies have come to recognize that they need to organize themselves into associations that can assert their interests and engage in collective bargaining with the corporation if they want to get a fair share of the value that they help to create.<sup>28</sup> At the same time, these associations are generally opposed to higher minimum wages for their employees. Yet, last year, franchisees joined forces with the Service Employees International Union in getting the California legislature to pass a bill that would have reduced the power of corporations to terminate franchise contracts and would have made it easier for

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<sup>24</sup> McDonalds Corporation, “The Ray Kroc Story,” at [http://www.mcdonalds.com/us/en/our\\_story/our\\_history/the\\_ray\\_kroc\\_story.html](http://www.mcdonalds.com/us/en/our_story/our_history/the_ray_kroc_story.html)

<sup>25</sup> Ibid.

<sup>26</sup> Eric Schlosser, *Fast Food Nation: The Dark Side of the All-American Meal*, Houghton Mifflin, 2001.

<sup>27</sup> Leslie Patton, “McDonald’s \$8.25 Man and \$8.75 Million CEO Shows Pay Gap,” *Bloomberg Business*, December 12, 2012, at <http://www.bloomberg.com/news/articles/2012-12-12/mcdonald-s-8-25-man-and-8-75-million-ceo-shows-pay-gap>

<sup>28</sup> Timothy Noah, “Disenfranchised: Why are Americans still buying into the franchise dream? In the tight-fisted world of fast food, it’s not just the workers who get a lousy deal,” *Pacific Standard*, March 4, 2014, at <http://www.psmag.com/business-economics/disenfranchised-fast-food-workers-quiznos-73967>. See also American Association of Franchisees and Dealers, “Bylaws First Draft,” at <https://www.aafd.org/bylaws/>; Coalition of Franchisee Associations Inc., “Mission Statement,” <http://www.thecfainc.com/leadership.html>.

franchisees to sell their businesses.<sup>29</sup> Bowing to pressure from the franchise corporations, however, the state's governor, Jerry Brown, vetoed the bill.<sup>30</sup>

At a company like McDonald's, franchisees and workers have a common interest in reducing the power of the corporation to distribute cash to shareholders so that a larger share of corporate profits can be allocated to the managers and workers who are actually generating the company's revenues on a daily basis. As we have seen, even without stock buybacks, McDonald's shareholders are being well rewarded with dividends for simply putting their money into the company's outstanding shares. Yet, in addition to ample dividends, almost \$3 billion per year has been flowing out of McDonald's solely for the purpose of manipulating the company's stock price – a use of corporate cash that long-term shareholders should oppose.

The value extractors who control resource allocation at McDonald's are unlikely to respond to requests to refrain from stock buybacks for the sake of the company's sustainable competitive advantage, not to mention for the sake of a fairer distribution of corporate profits and the rebuilding of the American middle class.<sup>31</sup> The elimination of stock buybacks will require action from the U.S Congress, starting with questioning the SEC about stock-price manipulation under Rule 10b-18.<sup>32</sup>

Ban stock buybacks, and then franchisees and employees at McDonald's can bargain between themselves about how to share the gains, both for augmenting current incomes and for investing in the value-creating capabilities of the businesses. Improved relations between franchise operators and franchise employees are bound to increase productivity in the stores. Ban stock buybacks, and tens of millions of U.S. households will have more disposable income to help absorb, if these households so choose, the somewhat higher prices for fast-food products that could help fund higher wages for fast-food workers. At McDonald's and hundreds of other leading U.S corporations, a ban on stock buybacks will help rebuild the middle class.

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<sup>29</sup> Patrick Clark, "Unions team up with fast-food owners," *Bloomberg*, August 8, 2014, at <http://www.bloomberg.com/bw/articles/2014-08-08/labor-unions-team-up-with-fast-food-owners-on-fair-franchising-law>

<sup>30</sup> Patrick Clark, "Franchisees lose battle over 'fairness' law," *Bloomberg*, September 30, 2014, at <http://www.bloomberg.com/bw/articles/2014-09-30/california-franchise-store-owners-lose-battle-over-fairness-law>

<sup>31</sup> This approach to the problem of stock buybacks is not unknown. In the summer of 2008, with oil prices high and with Exxon Mobil maintaining its perennial position as the nation's largest stock repurchaser, four Congressional Democrats wrote a letter to oil-industry CEOs asking them to, please, "pledge to greatly increase the ratio of investments in production and alternatives to the amount of stock buybacks this year and next by investing much more of your profits into exploration and production on the leases you have been awarded in the U.S., and in the research and development of promising alternative energy sources." Charles Schumer, Robert Menendez, Ed Markey, and Rahm Emanuel, "Democrats tell big oil: Spend more on production and renewable energy, less on stock buybacks before making demands for new drilling leases," U.S. Congressional Documents and Publications, July 31, 2008 at <http://www.menendez.senate.gov/news-and-events/press/democrats-tell-big-oil-spend-more-on-production-and-renewable-energy-less-on-stock-buybacks-before-making-demands-for-new-drilling-leases>. The oil executives paid no attention to this plea. See William Lazonick, "The New Economy Business Model and the Crisis of U.S. Capitalism," *Capitalism and Society*, 4, 2, 2009, pp. 46-47.

<sup>32</sup> For the first such inquiry by a U.S. Member of Congress, see Senator Tammy Baldwin's letter to SEC Chair Mary Jo White on April 23, 2015, at <http://www.baldwin.senate.gov/download/?id=2c78cb92-3afd-453c-bae3-44a875ac11ab&download=1>. For comments on the problem of stock buybacks by an SEC Commissioner, see Kara M. Stein, "Toward healthy companies and a stronger economy: Remarks to the U.S. Treasury Department's Corporate Women in Finance Symposium," April 30, 2015, at <http://www.sec.gov/news/speech/stein-toward-healthy-companies.html>

## Reforming a Broken Business System

Many trillions of dollars in stock buybacks over three decades have contributed to the concentration of income in the hands of the United States' richest households and to the erosion of middle-class employment opportunities.<sup>33</sup> In the last half of the 1980s it was mainly high-school-educated blue-collar workers who felt the impact of stock buybacks, which were often financed by plant closures and the massive downsizing of manufacturing jobs. In the 1990s stock buybacks began to have an adverse impact on the quality of employment for college-educated white-collar workers: One business corporation after another did away with the norm of career employment with a single company, which in the post-World War II decades had been the foundation of a strong middle class. Then, in the 2000s, a sharp acceleration in the transfer of employment to lower-wage areas of the world further undermined employment opportunities in America, this time for blue-collar and white-collar workers alike.

In today's globalized economy, more advanced schooling may make one better off, but it by no means protects one from the often devastating consequences of companies' taking jobs offshore any more than it does from the effects of buybacks at home. A major result of this increasing economic insecurity has been a race to the bottom in wages as members of the U.S. labor force scramble to find jobs, only to discover that many of those available pay less than a living wage.

As research carried out by the Academic-Industry Research Network has shown, using stock buybacks as a major mode of corporate resource allocation is not new. Yet it is only recently that the three-decades-old problem of the financialization of the corporation has begun to enter America's policy debates, in part because the phenomena of income inequality and middle-class fragility have become so obviously dire, but also because the conventional economic explanations have shed so little light on the nation's deteriorating economic conditions.<sup>34</sup> Policy remedies that might have seemed far-fetched in the US political economy a few years ago are now emerging as not only plausible, but urgent. In concluding this report, we will focus on three such remedies: banning stock buybacks, restructuring executive pay, and transforming corporate governance.

**Ban stock buybacks:** On its website, the Securities and Exchange Commission states that its mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."<sup>35</sup> In permitting, and even encouraging, massive stock buybacks under Rule 10b-18, the SEC is failing in its stated mission. It is not protecting investors, seen narrowly as shareholders who

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<sup>33</sup> William Lazonick, "Labor in the Twenty-First Century: The Top 0.1% and the Disappearing Middle Class," INET working paper, March 2015, at <http://ineteconomics.org/working-papers/papers/labor-twenty-first-century-top-01-and-disappearing-middle-class>

<sup>34</sup> William Lazonick, Philip Moss, Hal Salzman, and Öner Tulum, "Skill Development and Sustainable Prosperity: Collective and Cumulative Careers versus Skill-Biased Technical Change," Institute for New Economic Thinking Working Group on the Political Economy of Distribution Working Paper No. 7, December 2014, pp. 51-54, at [ineteconomics.org/research-programs/political-economy-distribution/papers/skill-development-and-sustainable-prosperity](http://ineteconomics.org/research-programs/political-economy-distribution/papers/skill-development-and-sustainable-prosperity)

<sup>35</sup> Securities Exchange Commission, "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation," June 10, 2013, at <http://www.sec.gov/about/whatwedo.shtml>



want to hold a stock for its dividend yield, or broadly as taxpayers who invest their money and workers who invest their effort in the productive capabilities that enable companies to make profits and an economy to grow.<sup>36</sup> In empowering insiders to manipulate the market, Rule 10b-18 has contributed to unfair, disorderly and inefficient markets. Retaining corporate earnings to provide for investment in both physical and human capital is central to boosting the productivity of the economy. An annual net outflow of \$400 billion per year from corporate treasuries to the stock market is doing the very opposite of facilitating capital formation for productive investment. The remedy is straightforward: Ban open-market repurchases by established corporations as well as large-scale tender offers designed to manipulate the stock market.<sup>37</sup>

**Restructure executive pay:** Currently the SEC is discussing reforms in executive-pay disclosure designed to make the determinants and components of executive pay more transparent, and thereby to facilitate the implementation of the Say-on-Pay provisions of the Dodd-Frank Act of 2010.<sup>38</sup> The proposed reforms will make the situation worse by tying executive pay to “total shareholder return.” We know what is wrong with executive pay: It incentivizes value extraction, not value creation. The purpose of the business enterprise is to produce competitive products on a sustainable basis. That means producing a high-quality product that potential users need or want, and then attaining a share of the market large enough to drive down unit costs so that the price of the product is one that users are able or willing to pay. Incentivizing executives to boost their stock prices by granting them high levels of stock-based compensation undermines the conditions that enable an enterprise to generate a high-quality product at a low unit cost. Executives focus on “returns to shareholders” rather than building competitive enterprise.<sup>39</sup> Executive compensation should be restructured to reward investment in productive capabilities and success in generating innovative products. A basic principle of executive compensation should be that the remuneration of senior executives is in step – rather than out of step, as is now the case – with the remuneration of all those working in the enterprise to make productive contributions.

**Transform corporate governance:** Among the world’s economies, America’s economy is especially burdened by the damaging ideology that superior economic efficiency results when companies are governed to “maximize shareholder value” (MSV). It is an ideology that is fundamentally flawed in its assumption that only shareholders take risk, by investing in the business enterprise

<sup>36</sup> See William Lazonick, “Innovative Enterprise and Shareholder Value,” *Law and Financial Markets Review*, 8, 1, 2014: 52-64.

<sup>37</sup> See William Lazonick, “Numbers show Apple shareholders have already gotten plenty,” *Harvard Business Review Blog*, October 16, 2014, at <https://hbr.org/2014/10/numbers-show-apple-shareholders-have-already-gotten-plenty>

<sup>38</sup> Michael Corkery, “S.E.C proposes rules on executive pay and performance,” *New York Times*, April 29, 2015, at [http://www.nytimes.com/2015/04/30/business/dealbook/sec-proposes-rules-on-executive-pay-and-performance.html?\\_r=0](http://www.nytimes.com/2015/04/30/business/dealbook/sec-proposes-rules-on-executive-pay-and-performance.html?_r=0)

<sup>39</sup> William Lazonick, “The Theory of Innovative Enterprise: A Foundation of Economic Analysis,” AIR Working Paper: #2013-05/01, at [http://www.theairnet.org/files/research/WorkingPapers/Lazonick\\_InnovativeEnterprise\\_AIR-WP13.0501.pdf](http://www.theairnet.org/files/research/WorkingPapers/Lazonick_InnovativeEnterprise_AIR-WP13.0501.pdf)

without guaranteed returns, and hence only shareholders have a valid claim on whatever profits are generated.

Not so. Taxpayers fund investments in the society's knowledge base and physical infrastructure, which makes them risk bearers and gives them a claim on profits if and when they are generated. Through the tax system, governments, representing taxpayers in general, seek to extract this return from corporations and individuals that reap the rewards of government spending. However, tax revenues on the prospective gains from innovation depend on the success of the enterprise in generating competitive products, and, moreover, tax rates on those gains are subject to change through the political process. Hence, returns to taxpayers, whose money has been invested for the benefit of the productive enterprise, are by no means guaranteed.

So too, workers regularly make productive contributions to the companies for which they work through the exercise of skill and effort beyond those levels required to lay claim to their current pay, but without guaranteed returns.<sup>40</sup> Any employer who is seeking to generate higher-quality, lower-cost products knows the profound productivity difference between employees who just punch the clock to get their daily pay and those who engage in learning to make productive contributions through which they can build their careers and, thereby, reap future returns in work and in retirement. Yet these careers and the returns that they can generate are not guaranteed.

The irony of MSV is that the public shareholders whom it holds up as the only risk bearers may never invest in the value-creating capabilities of a company at all. Rather, they may invest exclusively in outstanding shares, and that solely in the hope that the shares will rise in price on the market. Following the directives of MSV, a prime way in which corporate executives fuel this hope is by giving away corporate cash through stock buybacks.

In our view, the transformation of corporate governance to support value creation and constrain value extraction will occur only when the true value creators have direct influence on resource-allocation decisions. That means breaking up the network of clubs known as boards of directors that – in large part because its dominant figures are CEOs of other companies, all with an interest in stock-based pay – lives and breathes the broken ideology of MSV. Again the remedy is straightforward: Taxpayers and workers take risks in making investments in productive capabilities, and, for the sake of superior economic performance, should have influence over the management of those productive investments and the distribution of their returns if and when they occur. In our view, the employment instability and income inequality of the U.S. economy will not be addressed until representatives of taxpayers and workers – including franchisees in the case of a chain such as McDonald's – have seats on corporate boards.

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<sup>40</sup> William Lazonick, *Competitive Advantage on the Shop Floor*, Harvard University Press, 1990; Lazonick, "The Theory of Innovative Enterprise".

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