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AMERICAN COMPASS

Back to Basics for Corporate Finance

BAN STOCK BUYBACKS AND REPEAL BUSINESS INTEREST DEDUCTIBILITY

WHAT'S THE PROBLEM?

Most activity in financial markets has become disconnected from productivity and now entails **extracting capital from the real economy** and generating profit through financial engineering.

Domestic business investment is in long-term decline, American industry has been hollowed out, and companies are disgorging cash so quickly that they cannot even maintain their existing capital bases.

To further amplify shareholder returns, firms are leveraging their balance sheets with tax-advantaged debt that **discourages investment, reduces resilience, and shifts risk on to workers**.

U.S. INVESTMENT IS DROPPING

Companies operating in the real economy are supposed to raise capital from investors in financial markets, grow their businesses, and return some of the profits as dividends. But this is no longer the case in the U.S., where business investment has fallen significantly as a share of GDP. The corporate sector has become a net lender, handing capital back to financial markets and cannibalizing existing operations to boost short-term shareholder returns.

Firms use stock buybacks to manipulate and boost stock prices, while helping investors defer tax liability. Annual buybacks now total $1 trillion, roughly double the amount returned through dividends. Allowing interest deductability, meanwhile, encourages firms to prefer debt financing over equity and pursue highly leveraged business strategies. Corporations must pay tax on their profit before paying dividends, but they can pay interest with pre-tax dollars. Corporate debt levels are at record highs, and leave businesses more susceptible to economic shocks, more likely to be the *source* of an economic shock, and more likely to cut jobs in response. Rather than borrow to invest, companies often take on debt merely to fund even larger payouts back to shareholders.

WHAT'S THE SOLUTION?

Congress can discourage both practices through straightforward legislation.

Indeed, stock buybacks were illegal until the SEC promulgated Rule 10b-18 in 1982 to provide them safe harbor from insider trading prohibitions. The Tax Cut and Jobs Act of 2017 capped interest deductions at 30% of taxable income.

Congress should pass legislation that repeals Rule 10b-18 and amends the tax code to prohibit all deductions of interest payments from business income.

ENCOURAGING PRODUCTIVE INVESTMENT

With these changes in place, firms would remain free to return capital to shareholders via the traditional and transparent method of dividend payments. They would also remain free to acquire financing with debt.

But they would no longer have special tax incentives to engage in financial engineering and tax avoidance while reducing productive investment and increasing risk.

The tried-and-true practice of earning a profit through investing in growing a business would become relatively more attractive.

FREQUENTLY RAISED OBJECTIONS

"STOCK BUYBACKS HELP CAPITAL REACH ITS MOST PRODUCTIVE USES."
In theory, shareholders who sell stock in a buyback and receive cash in return could invest that cash in more productive uses. More likely, they use it to buy other assets (say, stock in other companies) which makes no productive investment but simply passes the cash on to other asset holders. Eventually someone might make a productive investment, or not. Even if they do, will it be a more productive use? There's no way to tell. What we can tell is that, as buybacks rise, trillions of dollars are permanently leaving the nation's capital base, and net domestic investment is falling.

"THERE'S NO DIFFERENCE BETWEEN BUYBACKS AND DIVIDENDS, SO NO POINT IN BANNING ONE OF THEM."
This is a self-defeating argument. If there's no difference, then we don't need buybacks. But of course, there is a difference. It's one that makes buybacks more attractive (thus their much faster growth in recent decades), and it's a reason to ban them.

"ELIMINATING THE DEDUCTIBILITY OF INTEREST WOULD REDUCE INVESTMENT."
If companies were taking on debt to finance real investment, this might be a concern. But evidence suggests they are not. Either way, the goal is not to raise the effective tax burden on investment but rather to equalize the burden across forms of financing. Any new revenue raised by eliminating deductibility could be offset by other tax changes that reward investment, so that the net effect would be to encourage more productive activity.

KEY FACTS

50% Decline in net domestic business investment as a percentage of U.S. GDP from the 1980s to 2018 [1]

3x Nominal increase in capital expenditures, 1988–2018[2]

6x Nominal increase in dividend payments, 1988–2018[3]

16x Nominal increase in stock buybacks, 1988–2018 [4]

5–10x Increase in bankruptcy risk after a leveraged buyout[5]

FURTHER READING

Oren Cass. "Confronting Coin-Flip Capitalism." *American Compass*, 2021.
A pro-market agenda for financial reform that includes this proposal.

Oren Cass. "The Rise of Wall Street and the Fall of American Investment." *American Compass*, 2021.
A primer on how financialization erodes the American economy's foundations.

Oren Cass. "The Corporate Erosion of Capitalism." *American Compass*, 2021.
A report analyzing declining business investment in the United States.

William Lazonick, "Profits Without Prosperity." *Harvard Business Review*, 2014.
A seminal essay describing the pitfalls of share buybacks and the collapse of business investment.

ABOUT AMERICAN COMPASS

Our mission is to restore an economic consensus that emphasizes the importance of family, community, and industry to the nation's liberty and prosperity. American Compass is a 501(c)(3) nonprofit organization.

For more information, visit americancompass.org

[1] Senator Marco Rubio. "American Investment in the 21st Century: Project for Strong Labor Markets and National Development," 2019.
[2] Analysis of Compusat Data from "The Corporate Erosion of Capitalism." American Compass, 2021.
[3] Ibid.
[4] Ibid.
[5] Brian Ayash and Mahdi Rastad, "Leveraged Buyouts and Financial Distress," 2019. "Critics Corner with Steven Kaplan." American Compass, 2023.