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Here's why share buybacks do not deserve the frosty response.

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We probably won't get a white Christmas. But the year's end is an appropriate time to consider one snowballing narrative about capitalism.

The past 12 months has seen an avalanche of opinion dump on "share buybacks" as economically damaging and corrupt. Building on the late 2017 criticism of Pfizer, Coca-Cola and Cisco Systems, companies that promised to increase dividends or buy their own shares following the US corporate tax rate cut, commentators have kept a hawk-like eye on repurchase activity through 2018.

The Financial Times editorial board recently said buybacks among American companies should be "ringing alarm bells". The Economist has called it "an addiction to corporate cocaine". UK economics commentator Charlotte Pickles claims buybacks are "the epitome of short-termism, fuelled by corporate greed". This week, US Republican senator Marco Rubio launched a further scathing attack from the Right on the pages of The Atlantic magazine.

The practice - purchasing shares from existing shareholders and reabsorbing the portion of the ownership held by these investors - is subject to two main criticisms from these interventions. First, repurchasing shares is said to come at the expense of productive investment that could improve productivity and boost wages.

Second, buybacks are believed to amount to manipulating the earnings per-share ratio to enrich managers with remuneration linked to it.

Combined, these effects are said to represent capitalism's worst features: a short-term unwillingness to invest driven by rampant executive self-interest.

Is such a narrative convincing? It's trivially true, as Rubio has written, that often "when a corporation uses its profits to buy back stock, it is actively deciding that returning capital to shareholders is a better activity for business than investing in the company's product or workforce".

But just as Keynesians warn against analogising from a single household to the macroeconomy, buyback critics make a similar mistake: assuming the decisions of an individual firm tell us about economy-wide investment. We only need follow the money to see how mistaken this is.

If existing shareholders are compensated for their shares, these funds do not disappear or get taken out of the economy. They become resources for investing in other firms, for venture capital funds, private equity, housing trusts, loans for small businesses or much else. Even if shareholders decide to consume the extra resources (unlikely, given they opted to invest them

previously), somewhere down the track there will likely be extra investment to meet their new demand.

Put simply, robust private-sector investment does not require every single profitable firm to be investing, and it may well be that mature, large profitable firms are not best placed to make the most of productive opportunities. If firms' managers recognise this, then investing for the sake of investing would not just be bad for the firm, but the broader economy too.

While share buybacks may be an alternative to within-firm investment, at a whole-economy level they simply amount to a reallocation of funds to better uses. Of course, there are other reasons firms engage in buybacks: they may want to borrow new money to repurchase shares and adjust the debt-equity capital structure of the business in the face of interest rate expectations, for example.

But overwhelmingly critics see things back to front: buybacks don't come with the opportunity cost of missed profitable investment. They are a reflection of the manager judging an absence of profitable investment opportunities in the first place.

This helps explain why the view that buybacks amount to manipulation of the share price and the earnings per share ratio is so misguided.

Yes, executives often do have remuneration packages linked to share prices or earnings per share. Share prices can be driven higher in the short term by buybacks (though well-designed contracts can prevent gaming for remuneration boosts around this). But the long-term path of the share price is affected by how profits are used.

If critics are right that firms engaging in buybacks are leaving lucrative investment opportunities on the table, we'd expect the long-run share price and earnings per share to be lower under buybacks than if investment had been undertaken. Contracts linked to share prices therefore deter buybacks.

And if shareholders had the same certainty as commentators about the supposed foolishness of buybacks, then share prices would fall today as owners learnt the firm's managers were making unwise decisions.

This suggests share prices rise after buybacks because investors perceive that funds that might have been badly invested are now being released.

As Hoover Institution economist John Cochrane has explained, there are strong incentives to keep money within a firm. Few CEOs would want to tell shareholders "we do not have any profitable opportunities".

There's pressure to engage in empire-building through mergers and acquisitions, lavish perks for management or even undertake new projects that may worsen profitability.

Far from being a massive problem inducing short-termism then, remuneration linked to stock prices can help mitigate against such wasteful investments.

Share buybacks are a mechanism to release funds accordingly. This matters for policy. Commentators have used examples of individual firms buying back shares to dismiss arguments that lower corporate tax rates will induce investment in the US. Yet the investment rate has ticked up since the corporate tax cut, in an environment when interest rates are rising.

The fear is politicians will run with these popular misconceptions, making it more difficult to buy back shares by changing the tax system, or even outlawing it. Even if they do not go that far, they might use their bully pulpit to dissuade firms from buybacks to encourage investment, the sort of pressure we see from President Donald Trump in relation to trade.

The result would be existing firms engaging in wasteful projects, and less capital available to the faster growing companies and industries of the future.

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