On Uneven Ground: How Corporate Governance Prioritizes Short-term Speculative Investments, Impedes Productive Investments, and Jeopardizes Productivity Growth

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On Uneven Ground: How Corporate Governance Prioritizes Short-term Speculative Investments, Impedes Productive Investments, and Jeopardizes Productivity Growth

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Abstract

The economic recovery after the Great Recession highlighted a continuous divergence between soaring profits and lagging investment. These trends are related at the corporate level, where corporate managers have stronger incentives to pursue short-term profit-seeking activities than to invest in longer-term productive activities, such as hiring and training people and investment in physical infrastructure. This prioritization results because the corporate governance system is biased towards the short run. The policy goals that we discuss aim to find a better economic balance between short-run and long-run goals by defining long-term performance measures and finding a better balance in the incentives of short-run and long-run oriented corporate stakeholders.

Keywords: Business investment; corporate governance; short-term speculation; long-term productivity growth.

[1] Luke Reidenbach co-authored this paper, while a research assistant at the Center for American Progress, Washington, D.C. The views expressed in this paper are the authors' and should not be attributed to the University of Massachusetts Boston or the Center for American Progress.

I. Introduction

The economic recovery after the 2008 and 2009 recession highlighted divergent economic trends. Corporate profits rose quickly starting in late 2008, while investments remained subdued. The resulting increase in cash reserves seemed to support share repurchases and dividend payouts more than long-term productive investments in physical and human capital. U.S. corporations thus continued to focus, as they had done in the years before the recession, on activities that could boost their share prices in the short run, possibly to the detriment of long-term investments and productivity growth.

Productivity trends underline the need for greater long-term investments. The productivity acceleration that started in the mid-1990s eventually disappeared in the mid-2000s. This productivity slowdown followed years of historically low levels of net investment – the actual additions to the country's capital stock after capital replacements have been accounted for. Key business investments, such as equipment or workforce development have languished, increasing the chance for slow productivity growth.

At least part of the change in the allocation of corporate resources can be traced back to the governance structure of U.S. corporations. The evidence suggests inherent biases in the corporate governance structure toward speculative investments and the short-run, away from long-run activities, such as increased capital investments, research and development, and hiring and training. These biases emerge since performance measures for corporate executives are tilted toward short-run profit-seeking and since other stakeholders, particularly boards of directors, shareholders, and regulators offer somewhat ineffective counterweights to move corporate resource allocations toward a better balance between short-run and long-run goals.

The discussion in this paper is structured as follows. Section II shows some macro economic trends that link productivity growth, investment, and corporate resource allocation. We show how these macro trends are reflected in the design of executive compensation in section III. Section IV then offers evidence on the inherent short-term biases in the U.S. corporate governance structure, which favor managers' short-term oriented resource allocations. Section V provides a brief discussion of the policy implications and section VI concludes.

II. Corporate resource allocation trends highlight short-term speculative focus

The aggregate data highlight a continuous divergence between soaring profits and lagging investment. Amid slowing productivity and low levels of business investment, companies have seen high profits, even amid the worst recession since the Great Depression. And a growing share of these profits has been dedicated to share repurchases and dividend payouts, while capital expenditures have received less attention.

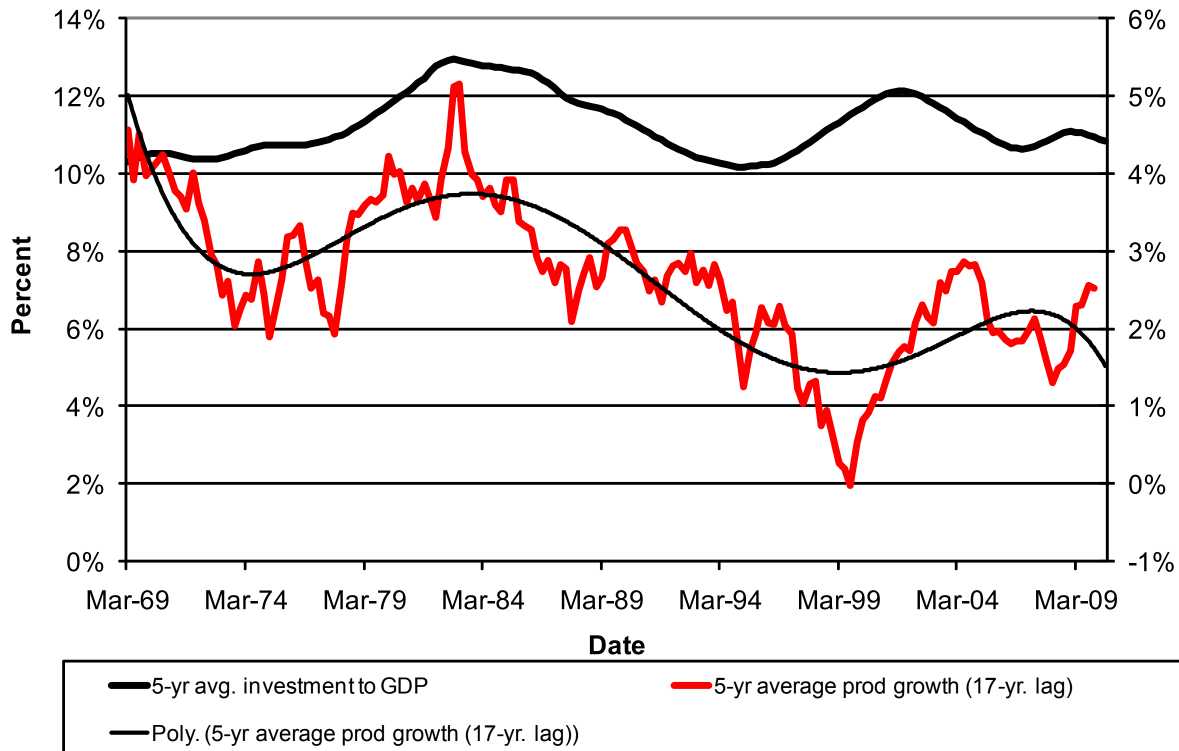
Slowing productivity growth and historically low net investment

Productivity growth has swung over the past two decades. Productivity growth accelerated in the mid-1990s after more than a decade of very low productivity growth, but then slowed again after 2004. The initial acceleration, associated with the information technology boom of the late

1990s,[2] was remarkable both because of its strength and its durability (Gordon and Dew-Becker, 2005). Long-term productivity growth, though, slowed again after 2004 (Kahn and Rich, 2006).

The prospect for renewed productivity acceleration in the future hinges on strong business investments in the present (Figure 1). Productivity growth seems to follow investment – in this case investment net of depreciation – with about a 17-year lag.[3]

Figure 1: Net investment and productivity growth, 1969 to 2010



Source: Authors' calculations based on Bureau of Labor Statistics, 2010, Output-per-Hour, Washington, DC: BLS, and Bureau of Economic Analysis, 2010, National Income and Product Accounts, Washington, DC: BEA.

But investment has been low, particularly after the previous recession started in March 2001. Gross non-residential fixed investment last peaked at 12.9% of gross domestic product (GDP) just before the previous recession started in March 2001. During the last business cycle, from March 2001 through December 2007, gross non-residential fixed investment averaged only 10.9% of GDP and never exceeded the 12.5% share in the first quarter of the cycle.[4]

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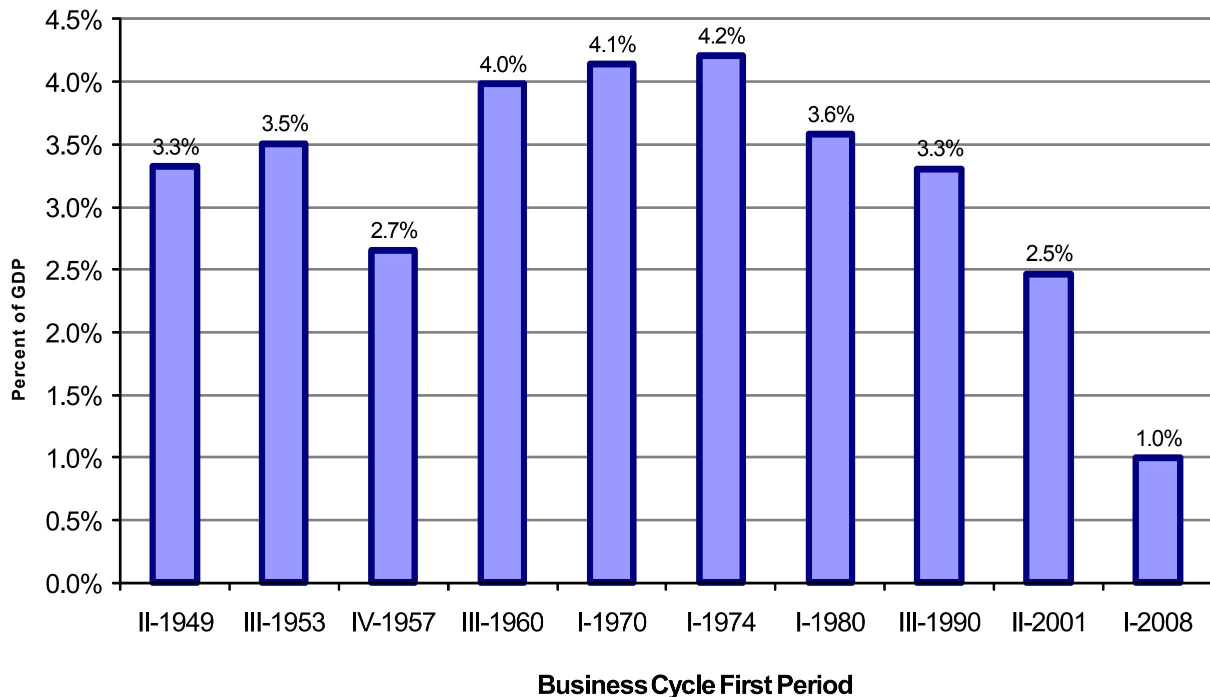
[2] A number of research studies have demonstrated the link between information technology investments and the productivity growth acceleration. See: Brynjolfsson et al (2007), Jorgenson et al (2005), Jorgenson et al (2008), and Oliner et al (2007).

[3] The lag is determined through a visual inspection.

[4] Authors' calculations based on Bureau of Economic Analysis, *National Income and Product Accounts 2010,* (Department of Commerce).

This is not the whole story. Businesses increasingly spend money to replace obsolete equipment that loses its economic value more quickly now than in the past, largely because computer and software depreciate more quickly than other investment goods. Faster depreciation requires businesses to spend more money just to maintain their capital base. This is evident in net investment trends – investment after depreciation is accounted for (Figure 2). During the business cycle of the 1990s, net business investment averaged at 3.3% of GDP, while it dropped to 2.5% between March 2001 and December 2007 – a relative decline of 19.4%. The decline continued after 2008, when net investment averaged 1.0% of GDP.

Figure 2: Net investnent to GDP, business cycle averages



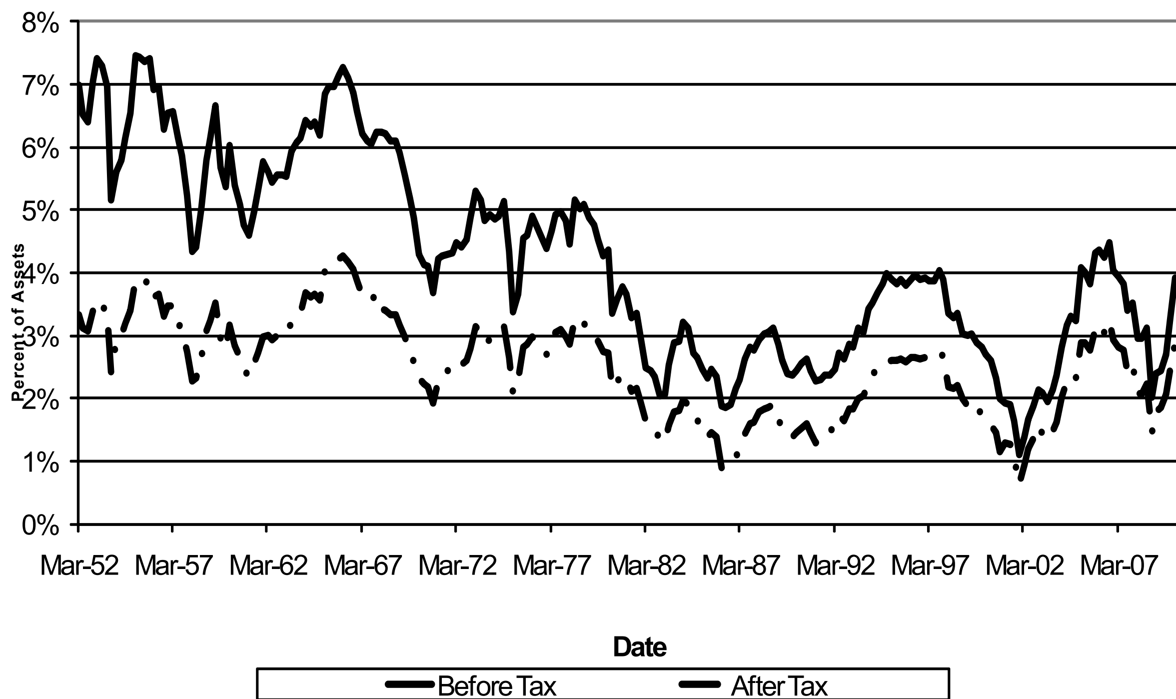
Notes: Authors' calculations based on Department of Commerce, Bureau of Economic Research, 2010, National Income and Product Accounts, Washington, DC: BEA.

High corporate profits

Low investment is not a result of insufficient corporate resources, but of corporate priorities. Comparatively high profits during the 2000s gave businesses sufficient resources to finance investments, but they instead used the funds for share repurchases and dividend payouts. Corporate profits rose sharply after the previous recession ended in November 2001 and again at the end of 2008, six months before the previous recession ended (Figure 3). Profit rates – profits to assets – in September 2010 had returned to the levels of early 2007, despite weak economic

growth in 2009 and 2010.

Figure 3: Non-financial corporate profit rates, 1952 to 2010

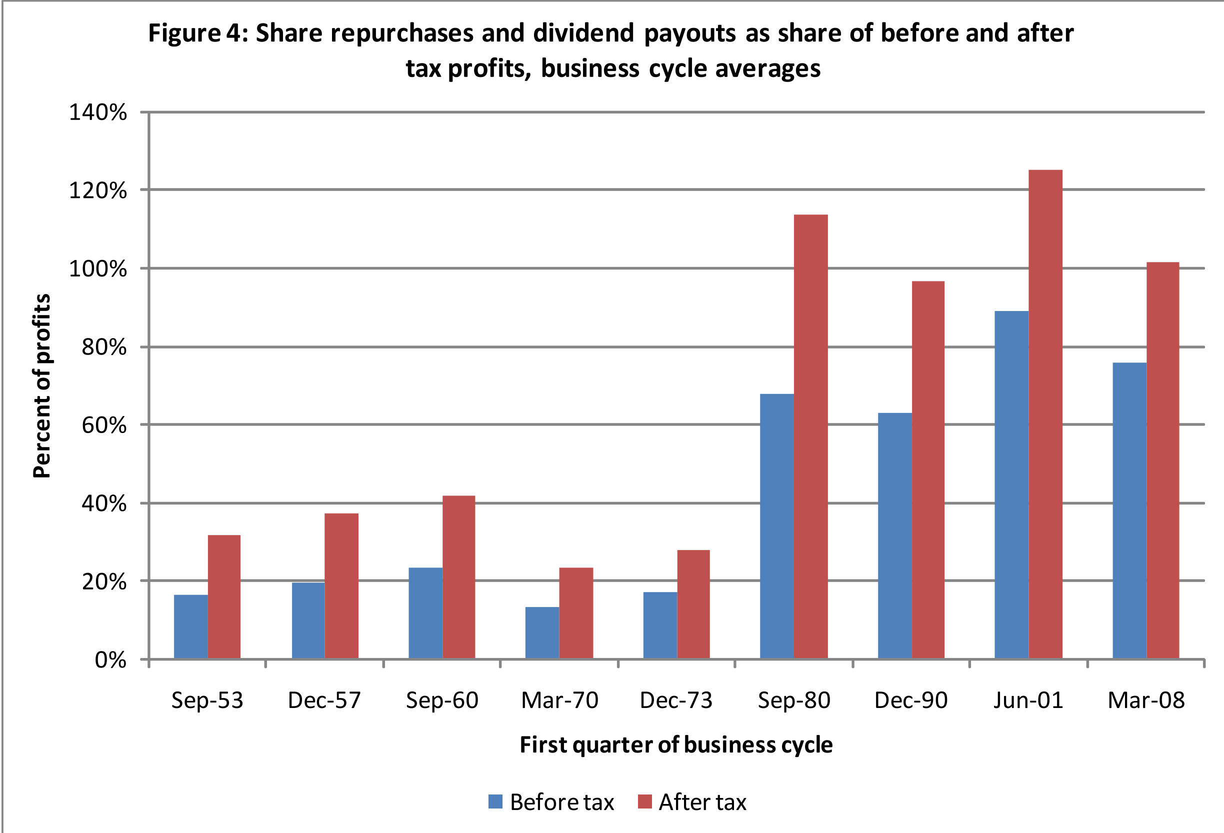


Notes: Authors' calculations based on Board of Governors, Federal Reserve System, 2010, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Companies have spent increasingly more of this profit on share purchases and dividend payouts as profits have risen to boost the value of stock and maximize immediate shareholder value. Profitable companies have the option of using retained earnings, profits that aren't redistributed back to shareholders, to invest. But often companies use profits to buy back their shares to prop up their share prices. When stock options and stock grants are issued to employees without any offsetting actions, a company's outstanding shares will rise and share prices will fall (Jolls, 1998). Share repurchases, rather, shrink the supply of a company's shares in the market, thus avoiding the dilution of share prices and resulting in higher share prices. Dividend payouts have a similar effect on share prices, as they increase the demand for a company's share. Share repurchases and dividend payouts, all else equal, thus reward short-term stock market speculation, but do so at the expense of long-term productive investments.

Share repurchases emerged strongly starting in the 1980s. American companies distributed more cash to shareholders through this method than through dividend payouts by 1998. Liang and Sharpe (1999) estimate that, if corporations continued share repurchases and dividend payouts at the pace of the late 1990s, firms would have to dedicate all future profits to these uses. During this period, the means necessary to pursue share repurchases and dividend payouts were increasingly generated through outsourcing, downsizing, and hollowing out (Weller and Bivens, 2005).

Share repurchases and dividend payouts have only increased in the 21st century. Half of Standard & Poor firms had stock repurchase programs in place by 2000 (Grullon and Ikenberry, 2000). On average, during the last complete business cycle, firms spent 125.2% of their after-tax profit on such resource allocations compared to an average 96.5% in the 1990s (see Figure 4). The trend continued after the recession started as firms spent more than 100% of their after-tax profits on share repurchases and dividend payouts between December 2007 and September 2010.



Notes: Authors' calculations based on Board of Governors, Federal Reserve System, 2010, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

III. The short-term, speculative bias in corporate governance

Corporate governance is comprised of institutions that are responsible for how a company allocates its resources. These institutions include corporate executives, shareholders, and the board of directors. Corporate executives are the highest ranking officers that are in charge of management of a company. The board of directors and shareholders are supposed to provide checks and balances on the actions of managers, to ensure the long-term health of the publicly chartered corporation. Managers, though, exercise a disproportionate amount of control over corporate resource allocations, as we discuss below.

Table 1 briefly summarizes the goal orientation and influence level each key stakeholder group. We discuss these aspects in greater detail further below. Table 1 illustrates that managers wield a disproportionate influence over corporate resource allocation because other stakeholders can offer only a limited counterbalance. And, managers have, by design, a short-term orientation in their resource allocation decision, which, due to economic realities, results in a prioritization of

speculative stock market activities, such as stock repurchases and dividend payouts, over investments. The resulting effects are reflected in the macroeconomic data shown in the previous section, where growing profits go hand in hand with decreasing investment.

Table 1
Summary of key stakeholders in corporate governance system

Stakeholder	Goal Orientation	Level of Influence
Management	Short-term due to pay-for-performance incentives	High
Short-term oriented institutional investors, e.g. hedge funds	Short-term due to own performance measures	High/Medium
Long-term oriented institutional investors, e.g. pension plans and mutual funds	Long-term due to benefit horizon	Medium/Low
Board of Directors	Both short-term and long-term	Medium

Notes: See text for discussion.

Executive compensation incentivizes short-term oriented resource allocation

The maximization of shareholder value has nominally been a top priority for corporate managers for the past three decades (O'Sullivan, 2003). The basic logic is that share price movements reflect trends in current and expected profits and that profit trends mirror productivity gains. Maximizing shareholder value – returns on shareholders' equity holdings – is thus supposedly equal to generating the strongest long-term productivity growth (Blair, 2008).

Shareholder value maximization requires active managers to increase short-term profits to boost stock prices. This implies that incentives for corporate executives are aligned with shareholder value maximization. This is generally accomplished with a carrot and stick approach. The carrot comes in the form of performance-based compensation, such as stock options and stock grants, that reward executives for share price increases after they have taken actions to boost shareholder value. The stick is a corporate takeover threat. A company that is performing poorly will theoretically see its stock price fall and thus become a likely takeover target. Managers at the helm of the takeover target will presumably lose their jobs (O'Sullivan, 2003).

This type of performance-based pay has not always been the norm (Lazonick, 2009). In the decades following World War II, performance-based executive compensation packages rose at a meager pace, with an annual average growth rate of 0.8%. It was not until the 1970s that

contemporary compensation practices proliferated. Shareholders, fed up with low stock returns, established shareholder value as the chief performance metric (O'Sullivan, 2003). Executive pay increases picked up in the late 1970s and 1980s, eventually growing at more than 10% per year in the mid-1990s (Frydman and Saks, 2007).

Both carrot and stick approaches assume that stock prices accurately reflect a company's performance. This assumption has been called into question, especially during the IT boom when companies that had never made a profit could easily raise enough funds to take over established profitable corporations. Research shows that stock prices often follow fads in the short-run and medium-term, creating boom and bust cycles, rather than mirroring underlying economic fundamentals.[5]

Corporate managers may thus be rewarded or punished for results that they have little control over. They may hence have an incentive to influence share prices, rather than actual corporate long-term performance. Share repurchases and dividend payouts can help boost stock prices, while the link between hiring and investment and stock performance is less tangible.

Corporate managers may also pursue short-term profit-seeking activities, such as hollowing out the company's productive base, to generate the resources for share repurchases and dividend payouts. Low investment, limited training of skilled workers, and downsizing of research and development activities will likely negatively influence corporate performance years and decades in the future, but will have little direct effect on the short-term and medium-term movements of a company's share prices. Less spending on capital and people means more money is available for share repurchases and dividend payouts. Lazonick uses the term "downsize and distribute" to describe the fact that a shrinking productive base mirrors growing efforts to directly boost share prices in the short run (2010).

Additionally, managers can use several processes to their advantage in the short term. Managers often operate with compensation packages that offer rewards even if share prices do not increase. These compensation packages are awarded by friendly compensation committees (Bebchuk and Fried, 2003), generated due to limited input by shareholders, and the result of outright manipulation, such as backdating of stock options (Heron and Lie, 2009).

These processes exacerbate the incentives for managers to prioritize short-term stock speculation over building a company's long-term productive base. In a 2004 survey of senior financial executives, for example, 80% of respondents said they would decrease discretionary spending, such as spending on research and development and human resources, if their company's stock might come in below desired earnings target at the end of the quarter (Graham et al, 2005).

Performance-based pay rewards executives for running risks to seek short-run gains. Many of these packages reward stock performance with stock options, which means that executives effectively reward themselves by aggressively pursuing short-run profits. For instance, when compensation plans contain dividend incentives, there are more dividend payouts and yields

[5] See O'Sullivan (2003) for a summary of the literature and Shiller and Campbell (2005) for some additional evidence.

overall (White, 1996). And executive excess and compensation practices fostered the pursuit of many risky investments that led to the crisis of 2008 (Holstein, 2008).

Performance-based compensation also often rewards executives even when they do not succeed. Sixteen and a half percent of CEOs whose companies' stock did not rise faster than Treasury bond yields still received raises in their total compensation between 2001 and 2005, for example (Weller and Sabatini, 2006). And, in a recent survey, firms with CEOs in the highest-paid ten percent earned abnormal returns over the following five years of about -13.0% (Cooper et al, 2010).

IV. Limits in the system of checks and balances

That these executive compensation practices have persevered is in part evidence that long-term oriented stakeholders offer a weak counterbalance to managers. When shareholders have concerns over investment decisions or how resources are allocated, they have several ways to fight back. They can sue the company, or wait until the annual election and vote out board members whose actions they deem excessive or harmful. They can also simply sell their shares or threaten to sell their shares. If shareholders no longer believe the company is making viable investments or sound decisions, they can simply cease to be investors (Gandhi, 2010). Shareholders selling their shares is the most potent and extreme example of shareholders taking action. There are other actions that shareholders can take against executives or boards if they still want to retain ownership of equities, including shareholder proposals, withholding vote campaigns, advisory shareholder votes, or voting against stock option plans.

There are, however, significant limits to shareholder activism. Shareholders have consequently failed to provide an effective counterbalance to management, and thus companies continue to make speculative investments at the expense of more productive investments.

The rise of the institutional investor

The most important change in the makeup of the corporate shareholder is of the increasing prominence of institutional investors over past few decades. Their rise can be attributed to an increasing reliance on managed assets by households. This in turn has led to a rising concentration of corporate equities in mutual funds, pension funds, and alternative investors. These institutional investors have become increasingly prominent, now making up a majority of total equity ownership. Institutional investors owned less than 10% of outstanding equities in 1952. By 2000, institutional investors owned a larger share than households, and in 2004 they owned 50% of outstanding equities for the first time. Retail investors, individuals who buy stock for their personal accounts, meanwhile went from owning more than 90% of company stocks to about 30% in 2009 (Aguilar, 2009).

The goals of institutional shareholder activism

Institutional investors across the board share one common goal: to increase profits and to maximize returns to shareholders. To reach that goal, institutional investors often fight for various intermediary steps that could increase the possibility of achieving this goal. These

preliminary steps include establishing independent compensation committees, removing poorly-performing management, and establishing independent board of directors who can better oversee the company's investment decisions.

All shareholders, not just institutional investors, face a structural hurdle in offering an effective counterbalance to management through the voting process at shareholder meetings. The proxy process, whereby shareholders propose alternatives to management policies at the annual shareholder meeting, is the primary tool for shareholder activists. Both votes cast against the proposal and abstentions are considered as opposing the activists' proposal and favoring management. Moreover, all votes are nonbinding, even if a proposal receives a majority of the votes. On the other hand, key members of the media and management will take note if even just a small share of shareholders opposes management decisions, managers, and board of directors. Managers often engage with shareholder activists on key issues important to activists before proposals opposing management and its decisions reach the annual shareholder meeting. The system is thus tilted toward managers, but not as much as the simple number of proxies brought to a vote or the share of votes they gather would suggest.[6]

But institutional investors are hardly homogenous. They have different interests and priorities for their investments and some are inactive in corporate governance. Many institutional investors do not actively engage in corporate governance issues or fight aggressive fights against corporate management, even though they represent potentially thousands of smaller retail investors. Mutual funds, for example, often refuse to engage management to try to influence returns at all (Taub, 2009). Mutual funds instead often turnover their asset holdings very quickly, walking away from less profitable investments instead of engaging with management.

But different types of institutional investors also possess disproportionate levels of influence, which is in part associated with the differences in their investment horizons. The competing interests of short-term institutional investors, such as hedge funds and private equity firms, and long-term institutional investors, such as those represented by the Council of Institutional Investors, ultimately create a bias toward short-term speculative investments.

Short-term institutional investors emphasize speculative investments

Short-term institutional investors, including hedge funds and private equity firms, are investors whose goals are to seek immediate share value increase and place emphasis on quarterly profit gains. Their investment horizons are short and thus, while they do care about long-term share performance, their primary concern is immediate profit creation.

Hedge funds look to maximize shareholder value through short-term profit gains. They frequently demand that companies repurchase shares or pay out dividends. A 2008 study by New York University's April Klein and Emanuel Zur finds that, on average, activism targets of hedge funds doubled their dividends and significantly decreased their cash. Hedge funds had a success rate of 60% when they engaged management on these issues (2008).

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[6] Weller, C., and White, D., 2001, "The New Kid on the Block: Unions are Playing their Institutional Investor Card", *Social Policy*, Vol. 31, No.3: 46-52.

Several advantages allow hedge funds to exert outsized influence on corporate decisions. First and foremost they face a more favorable regulatory environment than longer-term investors. They are largely exempted from the financial regulations set forth in important regulatory legislation, including the Securities Act of 1944 and the Investment Company Act of 1940. This allows hedge funds more flexibility with how they use their resources than longer-term institutional investors have, such as pension plans and mutual funds (Klein and Zur, 2008). Also, hedge funds face no incentives to diversify their stock holdings, giving them the potential to have considerable leverage over their target companies. And hedge funds can make off-exchange stock trades to claim more company equity. Further, since most hedge funds compensate their executives in part based on how well the fund does, their management has a personal stake in going after short-term profits (Brav et al, 2008). Finally, their interests are already aligned with the short-term interests of managers, which helps add to the existing bias towards short-term interests and reinforce distorted executive pay practices.

Hedge fund activism has consequently been able to fill a void left by lack of activism by long-term investors (Thomas, 2008), which we discuss below. As a share of total trading, hedge funds are not significant, but as a share of shareholder activism they wield significant influence over key management decisions. Hedge funds have waged successful shareholder activism campaigns since 2000. They have removed underperforming managers, stopped mergers or acquisitions, and pressed for a company's sale. The IRRC Institute for Corporate Responsibility reports that between 2005 and 2008, hedge funds have led or initiated 89% of proxy battles (Cernich et al, 2009).

Long-term institutional investors are reluctant activists

The largest bloc of institutional investors are long-term institutional investors, mainly private and public pension plans. These funds generally pursue a long-term investment horizon, because they need to pay benefits for decades to come. This requires pension funds to be primarily concerned with the long-term performance of the companies in which they are investing.[7] Thus pension funds seek governance solutions that preserve their long-term investments (Choi and Fisch, 2008). Pension plan investments also have a signaling effect. Pension funds held 38.6% of total institutional assets at the end of 2009 (The Conference Board, 2009). Other, smaller institutional investors will follow and thus create price swings and exacerbate losses.

One example of long-term institutional activism is how the nation's largest pension fund – the California Public Employee Retirement System (CalPERS) – has aggressively attempted to seek governance changes in order to protect its investments. Founded in 1932, CalPERS is the largest U.S. pension fund, with $195.5 billion under management as of October 31, 2009 (CalPERS, 2010). It was the use of proxy votes by CalPERS that helped give institutional investors more influence (Monks and Minow, 1991). CalPERS has augmented its influence further through the creation of the Council of Institutional Investors (CII), an influential shareholder advocacy organization that advocates on behalf of institutions with a long-term investment horizon (Smith,

[7] Another reason for pension funds to focus on the long term is that they often cannot unwind their holdings quickly without unduly influencing a company's share price. Pension funds and other institutional investors have very large holdings, which puts them in a leadership role. Their financial decisions will be imitated by other investors. Share sales by large institutional investors will thus result in disproportionately large price drops.

1996). CalPERS has consequently achieved periodic success in protecting its interests. Between the period 1987 and 1993, for example, CalPERS' activism increased its assets by almost $19 million at a total cost of $3.5 million (Smith, 1996).

Many long-term institutional investors, though, face several obstacles to seeking widespread change in management decisions. Public pension funds, for instance, as public entities, have political considerations that make it difficult to pursue riskier campaigns that hedge funds are able to pursue, making them more cautious about their activism (Kahan and Rock, 2007). And long-term shareholder activism has achieved limited results (Black, 1998), with some desired effects on share price in the short run, but fewer tangible results in improving the operating performance of targeted companies (Gillan and Starks, 2007).

The limits of and obstacles to effective, long-term shareholder activism

Short-term institutional investors wield a disproportionate influence over corporate governance decisions, particularly in relation to the allocation of corporate resources. Long-term investors, such as pension funds and mutual funds, face greater scrutiny from the entities regulating them than, for instance, hedge funds. Public pension funds also face public scrutiny of their activities, and mutual fund managers often list a myriad of reasons for their disengagement from shareholder activism, such as legal obstacles, contractual obligations, or lack of avid interest from shareholders. Most often, however, they are simply unwilling to engage managers (Taub, 2009).

There is also a temporal inconsistency that speaks against long-term shareholder activism. Short-term successes are easily observable and thus encourage activism, while there is obviously a longer lag between activism and the realization of long-term goals, which discourages strategic actions by long-term investors (Dobbs and Koller, 2005). Long-term performance outcomes are less tangible than short-term, speculative outcomes (Gaspar et al, 2005). This structural bias favors activity such as speculative investments and share repurchases – actions geared to immediately boost share value – over longer-term investments in physical and human capital.

Further, the cost of waging successful campaigns to change corporate decisions is high. This limits the number of shareholders who have the capacity and willingness to effectively protect their long-term interests. There are large costs involved in challenging the status quo. Generally a board will front the cost when it sends out the proxy. Shareholders who disagree with the board's selection must front the cost of an election campaign. In some cases, the costs of these campaigns reach millions of dollars (McCracken and Scannell, 2009). This is especially prohibitive for public pension funds, which have to be particularly wary of engaging in long and expensive campaigns due to public scrutiny. Funds such as CalPERS have shown the possibility of institutional activism by a long-term institutional investor, but the California institutional investor is also the biggest and most equipped to pursue these means. Most public pension plans lack the means to be as aggressive (Choi and Fisch, 2008). The high cost of activism means that it has remained a "minority pursuit" (O'Sullivan, 2003).

Short-term institutional investors such as hedge funds, meanwhile, retain an additional advantage in banding together. Such funds often collaborate and engage in "wolf pack" activity to minimize

costs and increase effectiveness. Other institutional investors do not work together in this way, citing regulatory hurdles that could require lawsuits and a long, drawn-out process (Black, 1998).

Another limit to long-term institutional activism is the lack of transparency in getting the necessary information. Shareholders have a difficult time directly seeing if their money is being handled properly. There is thus a large asymmetry between investors – even large institutional investors – and management and directors.

Here again are crucial differences between short-term and long-term investors. Studies show that short-run institutional investors such as hedge funds tend to have more information than other institutional investors and thus are better equipped to target the weakest companies for the right underlying reasons in an effort to boost share prices in the short term (Yan and Zhang, 2009). When long-term investors try to increase transparency at their target companies, they too can produce results, though this occurs less frequently. CII, for instance, produces a "Focus List" every year – a list of firms that underperform and have weak corporate governance – signaling to the target companies on the "Focus List" the intent to reduce equity holdings, which can make management more responsive (Ward and Griffin, 2009). The effect has often been a change in corporate governance practices by the targeted companies, although the outcomes for long-term performance are unclear (Wahal, 1996).

Long-term institutional investors hence increasingly acquiesce to management's decisions or simply do not engage at all due to these obstacles to long-term shareholder activism. For example, the rise of mutual funds and the relationship between advisors and their clients highlight the close alignment between institutional owners and management. In this relationship, the fund shareholder gives up its ability to advocate – they do not have the power to introduce shareholder resolutions or participate in a securities class action settlement (Taub, 2009).

Boards of directors provide limited counterbalance to managers

The board of directors theoretically wields the power to keep poorly performing executives accountable and to help steer the company in the right direction. In practice, the board of directors has a much more complicated relationship with both corporate managers and the shareholders the board is supposed to represent, relationships often hampered by conflicts of interest and a lack of true accountability. This can lead to boards that approve and promote excessive executive compensation packages that favor short-term oriented decisions, perpetuating activities such as share repurchases at the expense of longer-term investments.

Two problems deserve particular attention: lack of independence of directors and entrenchment. Independent directors are directors that have no relationship with management. While corporate executives' pay is determined by the board of directors and approved by shareholders, managers can often rig compensation decision in their favor. Managers can curry favor with directors by influencing who gets on the board of directors, influence the pay for the board of directors, or interact with board directors to entice favorable compensation packages. This means giving bonuses to helpful directors, donating to their charities, or conducting favorable business dealings with firms owned by the directors. Lucian Bebchuk points out that in general directors and CEO's have a close relationship, both because they know each other from prior work and

because they share much of the underlying values and preferences for corporate management and pay structures (Bebchuk and Fried, 2005). More specifically, CEOs and managers often have a hand in drafting the compensation plans that are presented to the board for approval, even influencing the independent compensation committee (Jensen et al, 2004).

Corporations and regulatory agencies have tried to address board issues such as the lack of independence. Over the past few decades independent directors have become increasingly common. The recent surge of independent boards and independent directors, for example, was meant as a policy response to the Enron and WorldCom scandals in 2002 (Bebchuk, 2009). Even before these scandals, independent directors, individuals unaffiliated with the company prior to becoming a director, were becoming increasingly common. Independent directors have become increasingly common, with 19% of S&P companies having a completely independent board chair in 2010, up from 9% in 2005 (Stuart Spencer, 2010). The rise of independent directors, though, has not had a notable impact on long-term share value and executive compensation packages and speculative investments (Gordon, 2006).

The organization of the board can play a critical role in its responsiveness to shareholders. There are two categories of boards – unitary boards or staggered boards. Unitary boards are boards whose directors stand for election by the shareholders every year while staggered boards are elected to overlapping terms. The most common form of a board of directors is the staggered board, which reduces accountability since it is hard to replace the board in its entirety.

Boards become entrenched due to this protection from removal of some board members. Entrenchment can lead to avoiding board duties. This avoidance can lead boards to engage in actions that directly undermine shareholders' stated needs. For example, boards will often bundle new charter provisions disliked by shareholders with well-liked measures to amend corporate charters in the board's favor, thus further entrenching their role by only pursuing little of what shareholders are seeking (Bebchuk, 2010). This can reduce performance, as Harvard Law professor Lucian Bebchuk finds that there was a reduction of firm value for companies with staggered boards (Bebchuk, 2004).

Limited policy moves in offering more balance towards long-term investments

A number of policy changes related to issues relevant for corporate governance have been enacted over the past two decades. A number of initial policy steps facilitated the short-term speculative corporate resource allocation. Later policy steps, though, have tried to move toward a better balance among performance measures, reducing short-term measures and increasing long-term measures, and to create a better balance among stakeholders who play key roles in corporate governance.

We briefly summarize a few key policy changes as examples in Table 2. We organize policies according to the venue in which they were enacted. These venues include federal regulation changes, federal legislative requirements, state legislation, and federal tax policy. The presentation in Table 2 and the accompanying discussion are meant to illustrate key policy goals and tools to reach them, rather than to offer a comprehensive list of any and all policy changes that have impacted corporate governance over the past two decades. The overarching storyline

that emerges, though, is that public policy has tried to move in the right direction, but has done so selectively – not using all of the tools at the disposal of policymakers – and not strategically. For example, there is no clear development of affirmative, long-term performance goals.

Corporate governance policies are a complex web of state and federal laws and regulations. Each state establishes its own requirements and demands related to corporate governance, including the legal nature of the relationships between the board of directors, shareholders, and management. Even though each state has its own sets of rules and regulations on issues ranging from shareholder protection to accounting rules and the enforcement of fraud, there are some similarities. Importantly, most states give corporations flexibility in establishing their own governance provisions, including how the board of directors is selected (Glassman, 2006). Management, board, and shareholders can do whatever is permissible under the relevant state law as long as they meet the regulation standards of the Securities and Exchange Commission.

On the federal level, the Securities and Exchange Commission (SEC) is the most prominent regulatory agency with external control over a company's governance structures. SEC regulations have played three key roles in the corporate governance realm in past decades. First, changes in the interpretation of SEC rules have facilitated share repurchases and thus enhanced the attractiveness of short-term speculative resource allocations. The SEC, for instance, created a "safe harbor" rule – SEC rule 10b-18 – under which corporations may repurchase their own shares without being charged with stock market manipulation under the Securities Exchange Act of 1934 (Hudson, 1982, Lazonick, 2009). The SEC further expanded the attractiveness of share repurchases for short-term purposes in 1991 by allowing executives to immediately sell their shares after exercising their stock options. Section 16(b) of the Securities Exchange Act of 1934 said that corporate directors, officers, or shareholders owning more than 10% of a corporation's shares are prohibited from making "short-swing" profits through the purchase and subsequent sale of corporate securities within a six month period (Lazonick, 2009). The SEC decided in 1991 to treat stock options as derivatives and thus shortened the six month waiting period from the grant date of the stock option, not from the exercise date. This made it easier for executives exercising their stock options to see short-term profits since the market risk associated with the six-month waiting period was reduced (Lazonick, 2009).

Second, later SEC regulations went to enforcing transparency and disclosure requirements in the governance processes. The SEC has issued a number of rules to increase disclosure of publicly traded corporations to their shareholders. These disclosure rules have centered on two key issues – executive compensation and stock price performance. Corporations have to disclose more about the cost of executive compensation, including the cost of stock options. Companies also have to include more information on the performance of their stock prices in their disclosures. The most recent SEC rule, 33-9089, which went into effect February 2010, for example, requires companies to report the value of stock options when they are awarded to executives and qualifications of directors that are nominated (SEC, 2009). Such provisions are important, but the SEC also defers to state bodies (Glassman, 2006). The primary result of changes in SEC regulations is more and better information for shareholders.

Third, the SEC has also increasingly narrowed the definition of the "ordinary business rule," under which management may reject shareholder proposals for proxy votes (O'Sullivan, 2000;

Weller, 2000). These changes occurred in response to shareholder challenges to the "ordinary business rule." The most recent change in the SEC's interpretation of this rule occurred in October, 2009, when the SEC further loosened this rule by excluding CEO succession planning from consideration of "ordinary business" (SEC, 2009).

Federal legislators have occasionally weighed on corporate governance issues, typically after severe crises have highlighted problems in the existing corporate governance structure. In the wake of the Enron scandals, the Sarbanes-Oxley Act of 2002 gave the SEC broad new authority to enforce new accounting and transparency rules (Kuschnik, 2008). The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act continues this trend, establishing additional transparency guidelines on executive pay. It also mandates that federal regulators evaluate whether executive compensation packages at regulated banks encourage excessive risk-taking – a prioritization of short-term speculative gains over long-term productive investments – and it requires regulators to devise rules to reduce such risk-taking (CRS, 2010). And the Dodd-Frank Wall Street Reform and Consumer Protection Act legislates a variety of reforms aimed at curbing excessive executive pay through increased transparency. Shareholders must have the opportunity to have a non-binding vote on executive compensation at least once every three years, shareholders also have a non-binding vote on "golden parachutes" given to executives, institutional investment managers have to report annually how they voted on shareholder votes regarding compensation issues, and there is greater disclosure of executive compensation relative to the financial performance of their company. The act also attempts to establish a greater balance between management and shareholders. It requires, for example, that compensation committees are comprised of only independent directors and gives committees the authority to hire outside consultants. And the act tries to create a level playing field between more heavily regulated institutional investors, such as pension funds, and less regulated hedge funds by extending oversight over hedge funds (CRS, 2010). The combination of these federal legislative changes increases transparency on existing corporate governance practices emphasizes prudent practices over risky ones, and gives key corporate governance stakeholders, specifically shareholders, a greater say in resource allocation decisions.

Table 2
Summary of select policy changes affecting corporate governance

Policy venue	Policy measure	Long-term performance measure		Balance between stakeholders
		Stock prices	Other performance measures	
Federal regulation	SEC "safe harbor" rule for stock repurchases to not count as stock manipulation in 1982	No, does not establish performance criteria	No, does not establish performance criteria	No, makes it easier to satisfy stock options and stock grants
	SEC deems stock options derivatives in 1991, shortening the required holding period after exercising options	No, does not establish performance criteria	No, does not establish performance criteria	No, makes it easier to gain short-term profits with stock options for executives
	SEC disclosure requirements	Yes, disclosure of long-term stock price performance	Yes, detailed cost of executive compensation	Yes, through greater transparency
	SEC narrowing of "ordinary business" rule	No, does not establish performance criteria	No, does not establish performance criteria	Yes, makes it easier for shareholders to introduce proposals for shareholder votes at annual meeting
Federal legislative requirements	Sarbanes-Oxley	Yes, greater oversight role for SEC	Yes, increased transparency to identify risk taking	Yes, through greater transparency
	Dodd-Frank Wall Street Reform and Consumer Protection Act	Yes, disclosure of long-term stock price performance	Yes, details on independent compensation committees, risk taking incentives in compensation packages, among others	Yes, through required votes by shareholders on executive compensation packages and through stricter regulations of less regulated entities, such as hedge funds

Policy venue	Policy measure	Long-term performance measure		Balance between stakeholders
State legislative requirements	Stakeholder legislation	Yes, some states encourage managers to consider long-term share performance, but these are generally nonbinding.	Yes, disclosure of impact on communities, but these are generally nonbinding.	Yes, requires consideration of interests of communities in decision making
Federal tax policy	Omnibus Budget Reconciliation Act of 1993 limits deductibility of executive wages	No, did not specify time frame for performance measures	No, focused just on executive compensation	No, tax changes only incentivize pay for performance for executives.
	American Job Creation Act of 2004	No, did not specify time frame	Yes, limits use of profits in 2005 for share repurchases and dividend payouts	No, only changes tax incentives for corporate resource allocation

Notes: See text for discussion and sources.

States have occasionally taken matters into their own hands. A number of states have contemplated and enacted so-called stakeholder legislation, whereby corporations chartered in the state would be required to consider the impact of their decisions on key stakeholders, such as workers and communities. The first such "stakeholder statute" occurred in Pennsylvania in 1987, and perhaps the most aggressive statute was passed in Wyoming, which declared that directors may consider the interests of a corporation's employees, suppliers, creditors, the long-term interests of the shareholders, and the impact of any action on communities (Adams and Matheson, 2000). Other states have enacted other statutes, though they all vary in scope and size, with different definitions of communities and stakeholders. Despite these differences they are generally nonbinding and have proven to be mostly ineffective (Singer, 1993).

Congress has also looked at the tax code with an eye toward performance-based pay packages. First, through the Omnibus Reconciliation Tax Act of 1993, Congress created section 162(m) of the tax code. This limited the deduction of executive pay to $1 million per year, but made it easier to deduct the costs of performance-based pay. In addition, the law increased disclosure requirements for executive compensation and for the performance targets for executive compensation. The tax changes incentivized companies to offer a larger share of executive compensation in performance-based pay, particularly since the costs of some performance-based pay components, such as stock options and retirement benefits, did not have to be fully disclosed (Cox, 2006). The intention was to keep executives accountable, but it emphasized the short-term focus in performance measures.

Second, the American Job Creation Act of 2004 established a tax rule for the use of a particular share of corporate profits to move corporations away from short-term speculative uses toward long-term investments. The law granted a tax holiday to corporations for repatriating overseas profits in 2005. The repatriated profits, though, could not be used for share repurchases and dividend payouts (Lazonick, 2009). This is another example of a policy that highlights undesirable corporate activities, but fails to create alternative, desirable longer-term performance measures.

The discussion of past policy steps shows that public policy has moved toward a different set of performance criteria and creating a better balance among stakeholders. Much still needs to be done. Consider, for instance, the establishment of long-term performance measures. The existing policy steps have identified a number of undesirable corporate activities – for example excessive risk-taking and greater allocation towards share repurchases and dividend payouts – and they have increasingly emphasized longer-term stock price performance, but public policy has not yet identified a set of performance criteria that could boost long-term productivity growth. Further, policy has gradually given a greater voice to shareholders and started to level the regulatory playing field between long-term and short-term investors, but this movement needs to continue. And policies need to pay more attention to the balance between boards and managers.

V. Moving toward policy reform

The issues outlined above foster an environment that puts the prospect of a strong economic growth over the long-term into jeopardy. Corporate governance reforms can offer more space for shareholder involvement in corporate decisions and incentives to discourage short-term

speculation. Our discussion has highlighted two goals for policy reform. First, there has to be a clearer definition and more consistent application of performance measures that could indicate faster long-term productivity growth. The desired outcome of a more long-term outlook in corporate governance is clear. Workers, businesses, and the economy need a more innovative business sector. There are, however, several pathways to get there, for example through increased money spent on research and development, more capital expenditures, and greater investments in skill development. Corporate governance needs to support the appropriate path for each corporation. Second, decisions in the U.S. corporate governance system are tilted toward short-term, speculative corporate resource allocation, for example through share repurchases. Policy needs to create a more level playing field between those stakeholders interested in seeing short-term, speculative gains and those who focus more on long-term, productivity enhancing strategies.

Short-term vs. long-term performance measures

Defining performance as shareholder value creation has succeeded in part because it provides an easy, low-cost, and accessible metric by which to assess management operations (Rappaport, 2005). Using short-term metrics to gauge corporate performance may be convenient, but such metrics have stymied business investments and have put into jeopardy the prospect for future productivity growth.

Efforts to tip the balance toward long-term investors and stakeholders must look seriously at other performance metrics. These metrics could include spending on research and development, the level of capital expenditures for new ventures, customer satisfaction, and the treatment of workers, specifically through investments in training and professional advancement.

One possibility may be to establish regulatory practices to emphasize long-term productivity growth, but leave the specific definition of corporate practices that could further the goal of long-term productivity growth to the regulating agencies. The Dodd-Frank Wall Street Reform and Consumer Protection Act may be a first step in this direction since it requires regulators to identify incentives for risk-taking. It may be worth considering if this approach could be expanded to define long-term, productive practices, rather than to just prevent speculative ones. This regulation could also be broadened to apply to nonfinancial corporations. Such a broadening, though, would also require that policymakers identify the right regulatory agency since not all financial stability regulators, for example the Federal Reserve, have authority over nonfinancial regulations, while others, such as the SEC, do.

Tax policy may open another venue to incentivize corporate managers to pursue a better balance between short-term, speculative and long-term, productive goals. After all, tax policy is already designed to create a compensation structure that holds executives accountable. One possibility may be to impose an excise tax on short-term speculative activities, such as share repurchases, which add little long-term productive value to a corporation.

Balancing stakeholder activism

The second lesson from past failures of shareholder activism to move corporations toward more long-term, productive investments is that the corporate governance system favors short-term

investors and short-term, speculative goals. Long-term oriented investors have moved to intermediate goals, such as proposing independent boards and independent compensation committees, advocating for shareholder votes on executive compensation packages, and greater accountability to short-term and long-term corporate performance in executive compensation packages, among others. These moves, though, often ended in non-binding shareholder resolutions and offered only a limited counterweight to short-term, speculative decisions.

The U.S. corporate governance system suffers from several flaws that structurally bias decisions toward short-run corporate resource allocations. These flaws include limited influence of shareholders over key decisions, uneven regulation of large institutional investors, lack of transparency of key decisions, and limited independence of directors and compensation committees.

The Dodd-Frank Wall Street Reform and Consumer Protection Act may have started to lay the foundation for a greater balance between short-term and long-term corporate pursuits by addressing some of these flaws, as we discussed in the preceding section.

These are important first steps in the right direction, but additional steps will be necessary to create a more balanced corporate governance system. These include lower costs for waging proxy fights that oppose corporate managers, and further leveling the playing field between short-term and long-term investors. Another step forward may be to consider creating effective stakeholder legislation that creates formal voices for workers and communities in corporate resource allocation decisions. Such additional steps could be pursued through federal or state legislation, since states charter corporations.

VI. Conclusion

Our discussion shows that corporate decisions are a critical ingredient in linking economic performance, the labor market, and long-term innovation. Corporate decisions tend to overemphasize short-run profit seeking to the detriment of long-term investments.

One goals are thus to better identify long-term performance measures and to find a better balance among key corporate governance players, specifically managers, short-term investors, long-term investors, and board of directors.

These goals can be pursued in four separate policy venues: (1) federal legislation, for example extensions to the recently enacted financial regulatory reform legislation; (2) state corporate laws, such as through so-called stakeholder legislations that require corporate managers to consider the interests of all involved parties; (3) federal regulation, for instance greater disclosure requirements or listing requirements for publicly held companies; and (4) tax policy, whereby long-term investments could receive favorable tax incentives relative to short-term speculative activities.

Given the fragility of the current economic recovery and the need for strong, widespread economic growth in the future, it will be critical to encourage companies to move away from speculative investments and to begin making the kinds of meaningful business investments that

will lay the foundation for future innovation and growth. Future efforts to address these issues should look at ways to nudge both managers and shareholders to think more long-term about performance and their investments. This means empowering shareholders across the board to be more effective activists, directly working to fix the power deficit that exists between short-run institutional investors and long-term investors, and creating more incentives for longer-term corporate investments.

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