



ECONOMIC POLICIES IN THE AGE OF GLOBALISATION

EPOG STUDENTS AND ALUMNI ASSOCIATION

The Investment-Profit puzzle(s).

**The good,
the bad
and the ugly
solutions**

The multiple relations between investment and profit oblige us to take all of them into account if we are looking for meaningful solutions for society.

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EPOG 2016ⁱ*

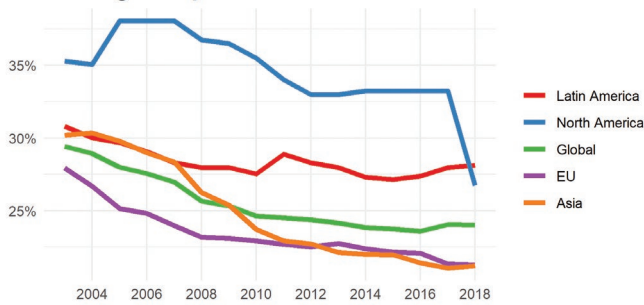
The 2000s have witnessed a so-called race to the bottom in corporate taxation (Figure 1). Corporate tax rates have diminished worldwide in the last years from Australiaⁱⁱ through Hong Kongⁱⁱⁱ to France^{iv} and there is always one common underlying justification: taxes have to be lowered in order to attract investment. The fact that the same argument is applied worldwide clearly illustrates that there still prevails an idea of a strong link between disposable funds and investment in policy-makers' public speeches (and minds?).

Probably one of the best examples of this is the recent case of the USA. By the end of 2017, the government was trying to pass a bill whose objective was to reduce the tax rate of individuals and enterprises. Regarding the latter, it was assumed that, by going from 35% to 21%, firms would have more funds, therefore they would increase investment and, with it, the number of employees. Hence, the name 'Tax Cuts and Jobs Act'.

In this context, on November 14th, 2017, the Wall Street Journal organized a meeting with a group of CEOs and Donald Trump's chief economic adviser at that moment, Gary Cohn. There, one of the newspaper editors asked the CEOs to raise their hands in case they planned to increase investment if the bill was approved. Few hands were up so Gary Cohn asked people again to raise their hands. Despite the uncomfortable situation, the result was relatively similar.^v

• **FIGURE 1**

Average corporate tax rate



Source: <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>

This lack of enthusiasm from the audience was, nevertheless, a perfectly reasonable outcome given the experience of previous years. In the very first moment that the bill started to be discussed, there was already enough evidence that most of the funds given back to enterprises, far from being reinvested in new plant, property and equipment would end up in the hands of those firms' shareholders. And this is what happened. Firms included in the Standard & Poor's 500 Index,^{vi} for instance, increased approximately 30% their distribution to shareholders from 2017 to 2018 (\$1.29 trillion dollars, more than half of the French GDP in 2016) compared to an increase of 10% in capital expenditures in the same period. What is more, the cumulative amount of dividends and buybacks for US firms from 2009 to 2018 has been almost \$8 trillion, something that represents a) 1.7 times the amount annually spent worldwide on education^{vii} and b) 13 times the amount spent on Europe on environmental protection in 2018.^{viii}

THE INVESTMENT-PROFIT PUZZLE(S)

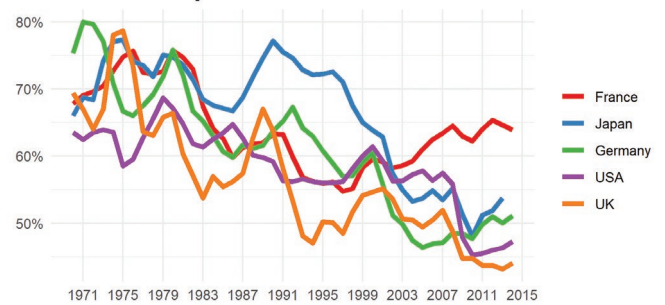
Hence, low levels of investment do not seem to be related to insufficient funds. In fact, the co-existence of high levels of aggregate profits with low levels of investment in developed economies has been one of the salient features of the last decades (Figure 2).

This weakening relation is particularly puzzling because it seems to run counter to economic intuition. Regardless of the conceptual framework or theory used, investment is always an addition to the current and future productive assets and capabilities of the firm and the society, while at the same time, a source of demand for the corresponding assets. Having this in mind, it is easy to see that investment is both a basis upon which future profits will be generated and present profits are made.

Moreover, different schools of thought recognize that the expected profitability is a fundamental determinant

• **FIGURE 2**

Investment-profit relation



Note: Investment calculated as a proportion of operating surplus. Source: OECD.

of investment, while current profits additionally serve as an internal source to finance investment (preferred to external alternatives such as debt or equity).

This is why a weakening link between profits and investment since the 1980s represents a puzzling situation. By acknowledging the different relations at stake we can also realize that, rather than being a puzzle, the current weakening relation actually involves several puzzles simultaneously: a) Why are not firms investing in spite of high profitability?, b) What are they doing with those funds?, c) Which alternative sources of effective demand compensate the reduction of investment at the aggregate level? and d) How can firms remain profitable with their productive and competitive capabilities diminished?

THE GOOD, THE BAD AND THE UGLY SOLUTIONS. THE US CASE

Solutions should therefore consider all questions listed before. In terms of c), for example, we find that different sources of effective demand have compensated the reduction of investment at the macroeconomic level, such as the increase in consumption from the richest segments of society, consumption fueled by debt by other segments, government deficits and external surpluses depending on the country.

Let's move to the other questions. Focusing on the US case, at the firm level, a hostile take-over movement and changes in payment structure in the 1980s aligned managers' interests with those of shareholders, shifting firms' goals of retaining and reinvesting in productive resources towards downsizing and distributing them^{ix}. These changes are usually referred to as the financialisation of the firm and the \$8 trillion distributed to shareholders that were mentioned before are partly an outcome of this.

The increased pressure from impatient shareholders offers plausible explanations for questions a) and b) but, without neglecting the effect of these pressures in terms of the decrease in investment, this explanation needs to

account, not only for the distribution of funds to shareholders *instead of* but also *in spite of* not reinvesting them. Basically, question d) needs to be answered.

The solution to this question implies recognizing that big firms have been able to sustain an increased profitability and distribution to shareholders by partially shifting profits and revenues to other bases apart from their own tangible accumulation. One popular answer is what could be denominated as a *financial turn of accumulation* hypothesis. The solution to the puzzle, in this case, might be simple: a shift in the activities of nonfinancial firms to financial accumulation and profits. Without denying its relevance for the business model of some firms, on aggregate terms this hypothesis is weak. Financial income averages 2.5% of non-financial corporations' total income since the 1980s (Figure 3), oscillating from the beginning of the 1990s until 2005, and then declining. In terms of assets, some of the alleged financial assets might actually reflect other activities in which non-financial corporations have been increasingly engaging such as tax avoidance, internationalization of production, activities refocusing and mergers and acquisitions.

Another type of answer is related to changes occurring in production. The concomitance of low capital accumulation and high distribution of funds to shareholders is found to be especially intense in high offshoring industries. By outsourcing production (i.e., relying on external suppliers), firms decrease their need to invest, being therefore able to distribute those funds to shareholders. Those industries with higher offshoring intensity have higher profit-to-investment ratios (Figure 4). On top of this, the attack on wages and labor conditions – with the distributive changes it brought about – is one of the salient features associated with financialisation and neoliberalism.

Large firms that outsource part of their production not only establish an asymmetric market structure with their various suppliers but also often manage to exercise increasing oligopoly power over their customers as sellers^x. While global competition pushes downward the share of

value captured by the offshored production segments, stricter international intellectual property legislation put upward pressure on both sides of the global value chain (research and development and design in the first part; marketing and after-sales in the last one).^{xi}

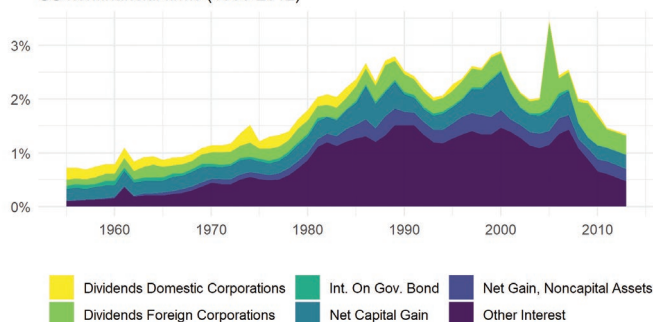
The growth in intangible assets (such as computer programs, software, patents, licenses, commercial copyrights, designs) along with organizational and managerial innovations can be understood as an interrelated process to that of offshoring as they allowed for specialization and substitution of tasks and activities performed by different firms, and the movement of the leading ones to the high-ends of global value chains.

But also, due to the specificities of these assets, firms' intangible intensity allows for higher market power (Figure 5). This is due to a variety of reasons. First, intangible assets such as patents can generate absolute monopolies for certain products. Second, in industries such as high-technology and telecommunications they can act as barriers to entry. Third, assets like brand names and trademarks can give pricing power. Finally, assets like copyrights for software can generate artificial scarcity for products that have a cost of reproduction that tends to zero.^{xii}

• **FIGURE 3**

Financial income relative to total income

US nonfinancial firms (1955-2012)

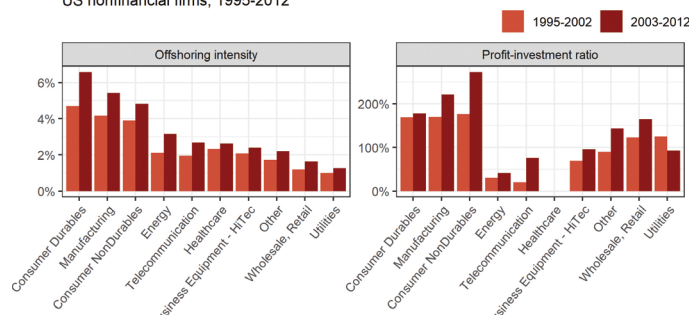


Source: Statistics of Income - Internal Revenue Service.

• **FIGURE 4**

Offshoring intensity and profit-investment ratio

US nonfinancial firms, 1995-2012

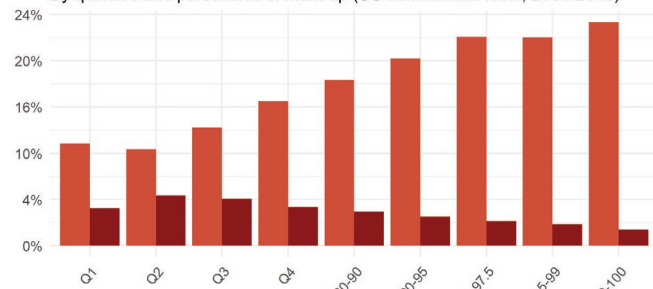


Source: Compustat and World Input-Output Database
 Note: Offshoring Intensity is the industries' average of all Intermediate Imported Inputs over output, the computed profit-to-investment ratio is the median.

• **FIGURE 5**

Tangible and intangible investments

By quintiles and percentiles of mark-up (US nonfinancial firms, 2000-2015)



Note: tangible investment, intangible investment calculated as a proportion of total tangible and intangible capital. Mark-up calculated as the ratio of sales over the cost of goods sold. Median values.
 Source: Compustat.

POLICY IMPLICATIONS

Given the situation summarized so far, a natural candidate to promote investment, already in the public debate, would be a definancialisation reform aimed at curtailing dividends and/or banning share buybacks. By putting together all the elements analyzed throughout this policy brief, my guess is that this measure would ameliorate the situation although it would be probably insufficient. I have shown that the dependence on own investment for big firms in order to sustain high profits has decreased during the last years. Therefore, a definancialisation reform could end up in different scenarios that do not involve higher accumulation rates but rather imply other uses of those funds such as a) mergers and acquisitions, b) accumulation of cash and liquid financial assets and/or c) reduced borrowing.

Therefore, the *definancialisation* reform should not be limited to curtailing dividends and/or banning share buybacks only, but should rather involve a deeper change in corporate governance that (re-)empowers all the stakeholders involved in the production process, especially workers (through higher wages) and the state (through higher taxes). Intangible assets facilitate profit shifting and tax avoidance. In this sense, a part of the funds being distributed to shareholders come, in fact, from those non-paid taxes. Another part of those funds is explained by the low wages paid in countries where production is offshored.

Along this policy brief, I have analyzed the conditions that allowed the combination of high profit and distribution rates with low capital accumulation to be sustainable from the *point of view of the firm*. I have also mentioned the sustainability conditions of this combination from a *macroeconomic point of view* such as the increase in upper classes' consumption or government deficits and external surpluses. However, it is the sustainability of this combination from a *socio-political point of view* that appears to be reaching its limit. Contrary to micro and macroeconomic sustainability, the current dynamics in terms of capital accumulation and uses of funds for unproductive purposes seem to be less sustainable from a socio-political point of view since they boost the rise in inequality and social exhaustion that we observe in many countries from the global north. For example, in 2015 the wealthiest 5 percent of US households owned more than two-thirds of all corporate equity, and the bottom 60 percent owned just 2.5 percent. Share buybacks have been mainly on their benefit, thus increasing inequality. Deep changes that involve curbing dividends and/or banning share buybacks and enforcing stakeholder perspectives of the firm could therefore be the first step in addressing the pressing low accumulation-high profits challenge and its consequences.

ⁱ This Policy Brief is based on my PhD Thesis, "The Profit-Investment Puzzle under Financialisation. An empirical enquiry on financial and productive accumulation by non-financial corporations"

ⁱⁱ Scott Morrison, Prime Minister of Australia, said that corporate taxes should be reduced "because it promotes investment, create jobs and drive growth".

ⁱⁱⁱ Hong Kong's Financial Secretary Paul Chan Mo-po, said in his speech on the Hong Kong Government's 2018/19 Budget that if "the Government puts forth various incentives such as additional tax deduction and government cash grants for start-ups, we believe more foreign investments will flow into Hong Kong."

^{iv} Current French President Macron justified the ongoing diminution of corporate tax from 33.3% to 25% by an incentive to invest. In his campaign program we can read: "La baisse du taux de l'impôt sur les sociétés est indispensable pour attirer les activités en France et soutenir la compétitivité de nos entreprises, en leur donnant les moyens d'investir." Available in <https://en-marche.fr/emmanuel-macron/le-programme/fiscalite-et-prelevements-obligatoires>.

^v This situation was described in many newspaper articles. It was also recorded and can be watched online in <https://www.youtube.com/watch?v=vlkC0JTzRvU>.

^{vi} A market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

^{vii} <http://gem-report-2019.unesco.org/chapter/finance/>

^{viii} https://ec.europa.eu/eurostat/statistics-explained/index.php/Environmental_protection_expenditure_accounts

^{ix} Lazonick, W., & O'Sullivan, M. (2000). Maximizing shareholder value: A new ideology for corporate governance. *Economy and society*, 29(1), 13–35. <https://doi.org/10.1080/030851400360541>.

^x Milberg, W., & Winkler, D. (2009). Financialisation and the dynamics of offshoring in the USA. *Cambridge Journal of Economics*, 34(2), 275–293.

^{xi} Durand, C., & Milberg, W. (2019). Intellectual monopoly in global value chains. *Review of International Political Economy*, forthcoming. <https://doi.org/10.1080/09692290.2019.1660703>

^{xii} Orhangazi, Ö. (2018). The role of intangible assets in explaining the investment–profit puzzle. *Cambridge Journal of Economics*. <https://doi.org/10.1093/cje/bey046>



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