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Short-termism: The False Debate.

The Harvard Business Review January–February 2021 includes an article by Lucian A. Bebchuk *Don't Let the Short-Termism Bogeyman Scare You* in which he claims that "articles…decrying the perils of short-termism…are long on alarming rhetoric and short on empirical evidence or economic logic… short-termism has not produced the predicted deterioration and decline." He assumes that "A major premise of short-termism worriers is that markets systematically undervalue long-term investments, which are consequently not fully reflected in stock prices" and seeks to show that this is inconsistent with the evidence.[1]

If the case against short-termism involved the stock market's reaction, its validity could be decided by examining stock market returns and Professor Bebchuk's claims would be fully supported. He seems also correct in assuming that the vast majority of those arguing against short-termism assume the "major premise" which he ascribes to them. Nonetheless he is in error when he claims that there is no evidence of economic damage, as short-termism has produced a marked slowdown in US (and UK) growth. I recently set out the evidence in *Productivity and the Bonus Culture*[2] and the references that follow are to the Figures and page numbers in that book.

In the 1990s there was a major change in the amount and way that corporate managements were paid (Figure 41 page 74). This altered their behaviour, as it was designed to do, but an unintended and unexpected consequence was a pronounced fall in fixed tangible investment after 2000 (Figure 10 page 29). This in turn led to the marked slowdown in the growth of the fixed produced capital stock (Figure 5 page 26), and thus in the growth potential of the economy, as the ratio of the capital stock to output is stationary (Figure 6 page 27). The result was the well-known slowdown in the rate at which labour productivity improved (Figure 3 page 24). That these were the consequence of the changes in corporate behaviour that followed the new approach to management remuneration is shown by the altered response of corporate investment to returns on equity (RoE) (Figure 39 page 70 with the change in the correlations shown in Table 12 page 71) and to the level of corporation tax (Figure 40 page 71 with the change in correlations shown in Table 13 page 72).

[1] Professor Bebchuk has argued similarly at greater length in his paper *The Myth that Insulating Boards serves Long-term Value*. *Columbia Law Review*, Vol. 113, October 2013, pp.1637-1694.

[2] *Productivity and the Bonus Culture* by Andrew Smithers Oxford University Press (2019).

Professor Bebchuk argues, I think correctly, that shareholders do not appear to have suffered from the decline in corporate tangible productive investment. There is a strong case that they will not do so very much even over the long-term. The case against short-termism is not that it is damaging for shareholders, but that it harms labour productivity and slows economic growth. I have, however, considerable sympathy with him over this debate, because the vast majority of attacks on short-termism have not been supported by evidence.

Professor Bebchuk does not discuss the impact that the change in incentives has had on economic growth but neither, as far as I can find, do those he quotes who claim that short-termism has damaged the economy. Both sides of the argument are presented in terms of the neoclassical consensus which assumes that in "normal times" i.e. before the arrival of short-termism, companies sought to maximise the present value of their net worth, which is often called "profit maximising" and that this produced satisfactory long-term results for the economy.

Sydney Smith, on seeing two Edinburgh housewives abusing each other from the second floor windows across the street, remarked "They will never agree they are arguing from different premises". The problem in this debate is different, it seems to arise from both sides accepting several false premises common to the neoclassical consensus. It is a common and I think a valid criticism of this consensus that it has failed to include finance in its models and, as this debate is about financial macroeconomics, i.e. the impact of changes in corporate finance on the behaviour of the economy, neoclassical economics does not provide a model which can be usefully used to resolve the issues raised. It has long been argued by some economists that mangers do not behave as if they were acting in the long-term interests of shareholders, at least if that is understood as maximising the present value of long-term corporate net worth. The utility functions of shareholders and managers are sufficiently different to make it essential to separate the private sector between households and companies, with managements consequently behaving in different ways to those which neoclassicists assume. "We start from the proposition that corporate directors may subject corporate policy decisions to utility functions of their own."[3]

[3] *The Economic Theory of "Managerial Capitalism"* by Robin Marris (1964) Macmillan.

I have set out elsewhere the points where the assumptions of the neoclassical consensus are at odds with the observed behaviour of companies and the economy,[4] and I don't have the space to summarise them satisfactorily here. I merely point to the evidence that Professor Bebchuk is correct in holding that short-termism has not damaged the interests of shareholders but wrong to claim that it has not damaged the economy. The absence of conflict between economic growth and shareholders' interests follows from the fact that the return on equity is unaffected by growth. The long-term real return on equities is mean reverting around 6.4% p.a. and this has remained constant despite and without any relationship to fluctuations in growth and, in the absence of capital destruction through war, it has applied internationally not just in the US. Equity returns in the stock markets of different economies have not depended on their growth rates. If we wish to speed growth, as we should, we need to alter the current incentive for corporate managers to lower tangible investment and thus growth and we cannot harness the self-interest of shareholders to achieve this.

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[4] *The Economics of the Stock Market* by Andrew Smithers Oxford University Press forthcoming.