The economic roots of Trump’s win over Clinton

At the core of ordinary Americans’ anger was predatory value extraction that hit the middle class hard

Shin Jang-Sup
For The Straits Times

The revolts of “angry Americans” is now broadly seen as one of the causes of the unexpected victory of Mr. Donald Trump in the United States presidential election. So what was it that made American voters so angry?

In my view, “predatory value extraction” was at its core. Since the 1980s, US business corporations have been restructuring employment relations and financial institutions. The matrix of the day that American corporations should recover their international competitiveness against their Japanese and German counterparts through “corporate restructuring.” American workers’ wages and the success of the restructuring. Often missing in the story is the pain caused by restructuring as individuals as well as society. Many people lose their jobs and are forced to find new jobs in new places. Often, they have to accept cuts in their salaries and benefits.

Individuals only feel that it is worthwhile to have undergone this painful process if they get some benefits from the restructuring in the end. Society can enjoy a “virtuous cycle” if the benefits of restructuring is shared broadly by its members.

Let us delve a little on whether the US economy as a whole was really successful in its restructuring. I have strong reservations that it was successful as a whole. However, there is no disagreement that the benefits and costs of restructuring have been distributed unevenly.

For nearly half a century before the 1980s, labour productivity increases were parallelled by wage increases. The US middle class emerged and prospered during the period. Since the 1980s, however, wage increases have not kept up with labour productivity increases. Under the incessant pressure for restructuring, US workers’ wages have been cut lower than what they contributed to their companies. From the mid-1990s, they began working longer hours per the Japanese workers who used to define as “ants.” The proportion of “excess workers” in the total workforce also increased sharply from 10.5 per cent in 2000 to 15.8 per cent last year, according to professors Lawrence Katz and Alan Krueger. That’s an increase of 4.9 million workers, implying that nearly all of the net employment growth in the US during the period occurred in contingent work.

UNIONS ALLIANCE

Who then took most of the benefits from the restructuring? They were a small group of financial investors and top executives whose compensation was tied significantly to stock options and stock dividends. This was because the US restructuring was primarily led by the stock market and its focus lay in “maximizing shareholder value.” In the process, the welfare of workers and long-term sustainability of corporations were often sacrificed. This “unholy alliance” of financial investors and top executives is evident. One can examine how US corporations actually distributed their profits and paid workers.

For the decade from 2006 to last year, US corporations’ total net equity incomes—that is, new share issues less taxes taken off the market through buybacks and merger-and-acquisition deals—was minus US$4.6 trillion (US$5.94 trillion). The US stock market has been the single biggest transaction from US corporations, although the tendency of net outflow has existed on a multi-year scale since US stock markets of advanced countries. Reanalyzed by William Lazosnick of the University of Massachusetts Lowell and his research team on the Academic-Industry Research Network shows that for the decade from 2006 to last year, the 499 companies comprising the S&P 500 expended US$39 trillion on stock buybacks, representing US$3.6 trillion per sector and a US$2.7 trillion. The US$3.9 trillion is a monstrous amount of money that could have been utilised for job creation and long-term investment for corporations. But US shareholders and top executives drew down the money only to purchase stocks and get rid of them in the name of “maximising shareholder value.”

Another 36.7 per cent of net income, US$2.67 trillion, was spent on dividends during the period. US corporations had already maintained higher dividend payout ratios than their counterparts in Western Europe or Asia. But the payout ratio increased even more during the process of restructuring after the 1990s. Much of the remaining 9.7 per cent of net profits, US$707 trillion, was held abroad, sheltered from US taxes.

While pressing for restructuring, financial investors argued that US corporations held on to too much “free cash flow” that should be “divided” to shareholders as buybacks and dividends. However, what the corporations actually gave away was much more than free cash flow. Many of America’s largest corporations routinely distributed more than 10 per cent of net income to shareholders. They then generated the extra money by further restructuring their workforce, selling off businesses or taking on more debt. Legally, shareholders are residual claimants who are supposed to get part of the profits after paying wages, business costs, taxes and so on. However, they have made their claims the first priority and have instead made wages and other business costs residual. What they have engaged in was no more than predatory value extraction.

SHAREHOLDER DICTATORSHIP

There are several factors that made financial investors such strong value extractors. One of them is the ever-strengthening trend of “fudged” capital. Shareholders by institutional investors in the US passed the 20 per cent mark in 1970 and has continued increasing to reach about 70 per cent now. Institutional investors, as a group, are absolutely the largest shareholders of US corporations and the US is now better described as “Investor America” than “corporate America.”

Moreover, the shareholders are extremely concentrated in a small number of investors. The top five institutional investors hold 3.5 per cent of US stocks and the top 10 held 42.4 per cent of US stocks in the middle of this year. BlackRock, the largest institutional investor with US$7.4 trillion of assets under management, for instance, is the single largest shareholder in one of every four US companies and had 5 per cent or higher shareholding in 2,500 companies.

The power of institutional investors to extract value has increased, typically because US financial regulations were substantially revised in the 1980s and the early 1990s towards strengthening their power. US regulations were heavily influenced by the rhetoric of institutional activism and, ignoring the reality of the rapidly growing power of institutional investors, treated them as weak “minority shareholders” who should be allowed to act together to challenge “aristocratic corporate management.”

Currently, activist hedge funds are the investor group that exploits its gap between financial regulations and its actual power most effectively for their own profit. By acquiring a small fraction of outstanding corporate shares, they criticise incumbent management and request restructuring and cash distributions to shareholders. More often than not, other institutional investors and proxy advisory firms support their claims. “Wolf pack attacks” and “co-investors” have rapidly become a conversion in the US stock market. It is worthwhile to note the fact that the acceleration of predatory value extraction from US corporations coincided with the rise of hedge-fund activism in the middle of the 2000s.

The US economy is now run by “shareholder dictatorship,” not by “shareholder democracy.” Even among shareholders, only a few took the lion’s share of the benefits of the extraction. The US middle class has been disproportionately in the process and the “pea per cent versus 0.1 per cent” frame has been solidified. The presidential election was then determined by which candidate was in a better position to cope with this dismal state of the disappearing middle class.

TRUMP TO THE RESCUE?

There is no need to overstate to believe that Mr. Trump has the leadership qualities to rectify the current situation. He was born into a wealthy family that made up the top 1 per cent. He has engaged in large-scale tax avoidance, broken contracts, and shifted losses to other participants in his businesses to maintain his lavish and flamboyant lifestyle. He also remarked last year that he would have appointed his friend, Mr Carl Icahn, a leading corporate raider and hedge-fund activist, as Treasury Secretary. If elected president, Mr Trump’s right-wing tendency to question America’s problems to outsiders, such as immigrants and trading partners, can be seen as a reflection of his limited ability to solve the problem of predatory value extraction within the US. However, many angry Americans cheered his political rhetoric of “making America great again.” It remains to be seen whether Mr. Trump, now the President-elect, is willing to close the gap between his rhetoric and the reality of the American economy.

stopiong@spah.com.sg

• The author is an economics professor at the National University of Singapore and a former adviser to Korea’s finance minister.