VIII. Creating a New Balance in the Corporate World: Promoting Stable Employment Using Long-Term Growth

On Uneven Ground: Corporate Governance and Corporate Investments

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Abstract

The economic recovery after the Great Recession showed a continuous divergence between soaring profits and lagging investment. These trends are related at the corporate level, where managers have more incentives to pursue short-term speculation than to invest in longer-term productive capacity. This prioritization results because the corporate governance system is biased toward the short run. The ensuing policy goals to find a better economic balance between short-run and long-run goals are to define long-term performance measures and to find a better balance in the incentives of short run– and long run–oriented corporate stakeholders.

Introduction

The recovery after the 2008/2009 recession showed profits rising quickly, starting in late 2008, amid subdued investments. Corporations instead used their resources for share repurchases and dividend payouts. 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, though, underline the need for more investments. The productivity acceleration that started in the mid-1990s eventually disappeared in the mid-2000s. This productivity slowdown followed years of low levels of net investment.

Part of the reason for this corporate resource allocation is the corporate governance structure. It exhibits inherent biases toward short-term, speculative investments, away from capital investments. These biases emerge because performance measures for corporate executives are tilted toward short-run profit seeking and because other stakeholders, particularly boards of directors and shareholders, pose somewhat ineffective counterweights to move corporate resource allocations toward a better balance between short-run and long-run goals.

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Corporate Resource Allocation Trends Highlight Short-Term Speculative Focus

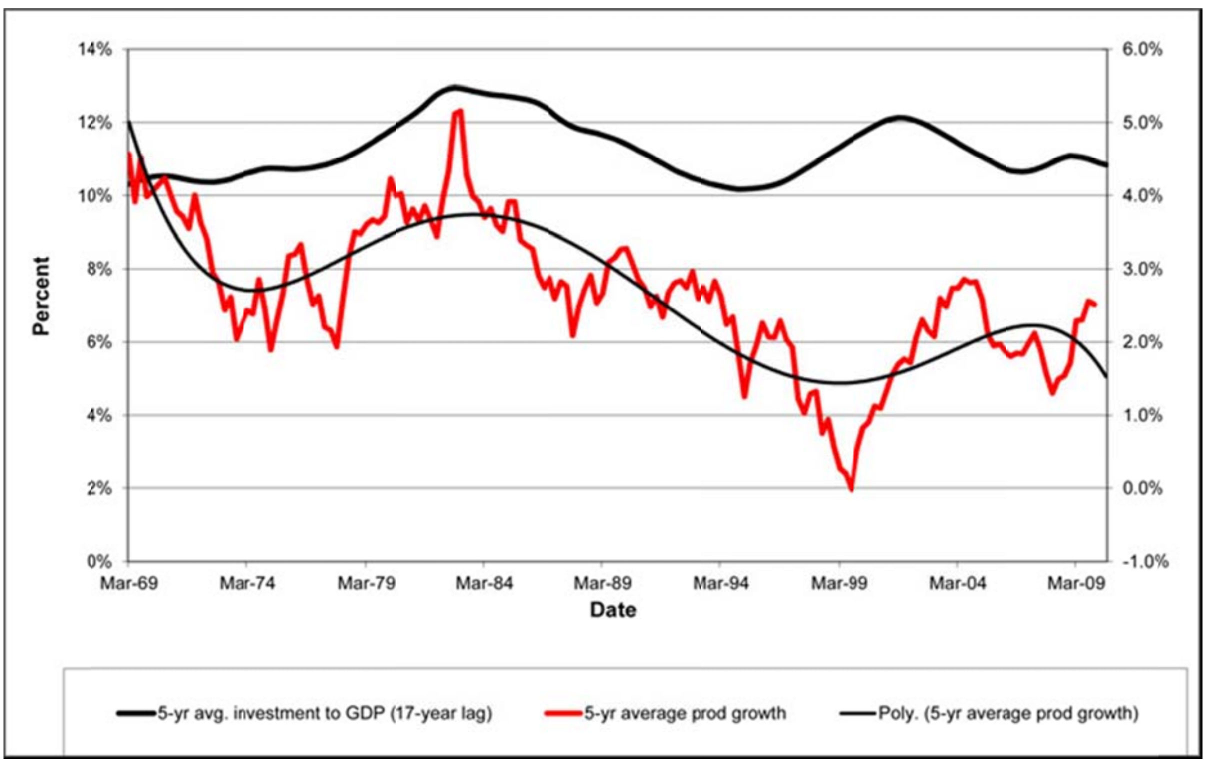
The data highlight a continuous divergence between soaring profits and lagging investment. Amid slowing productivity and low levels of business investment, companies have seen high profits. And, a growing share of these profits has been dedicated to share repurchases and dividend payouts, while capital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

Slowing Productivity Growth and Historically Low Net Investment

Productivity growth has swung in past 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
Investment and Productivity Growth, 1969–2010

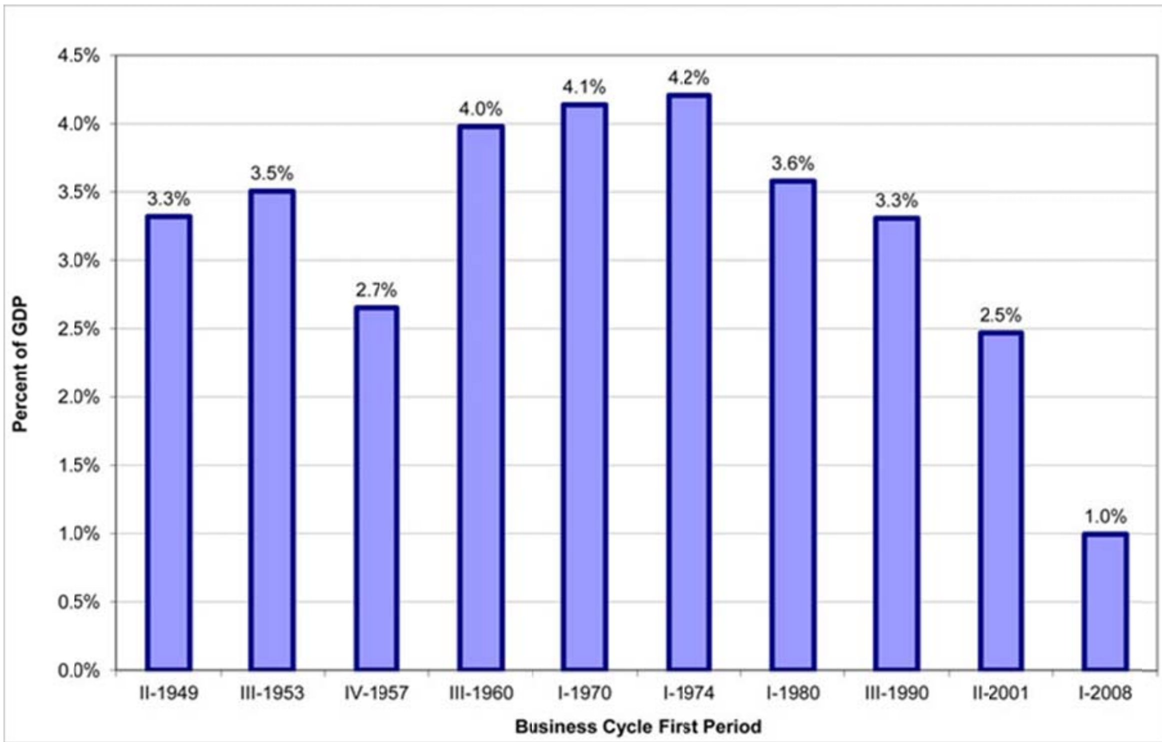


Source: Authors' calculations based on Bureau of Labor Statistics 2010, Output-per-Hour, Washington, DC: BLS and Bureau Economic Analysis 2010, National Income and Product Accounts, Washington, DC: BEA.

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, it averaged only 10.9% of GDP and never exceeded the 12.5% share in the first quarter of the cycle.[4]

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 computers 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 to 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 Investment to GDP, Business Cycle Averages



Source: 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 reflects 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 from the end of 2008, six months before the last 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

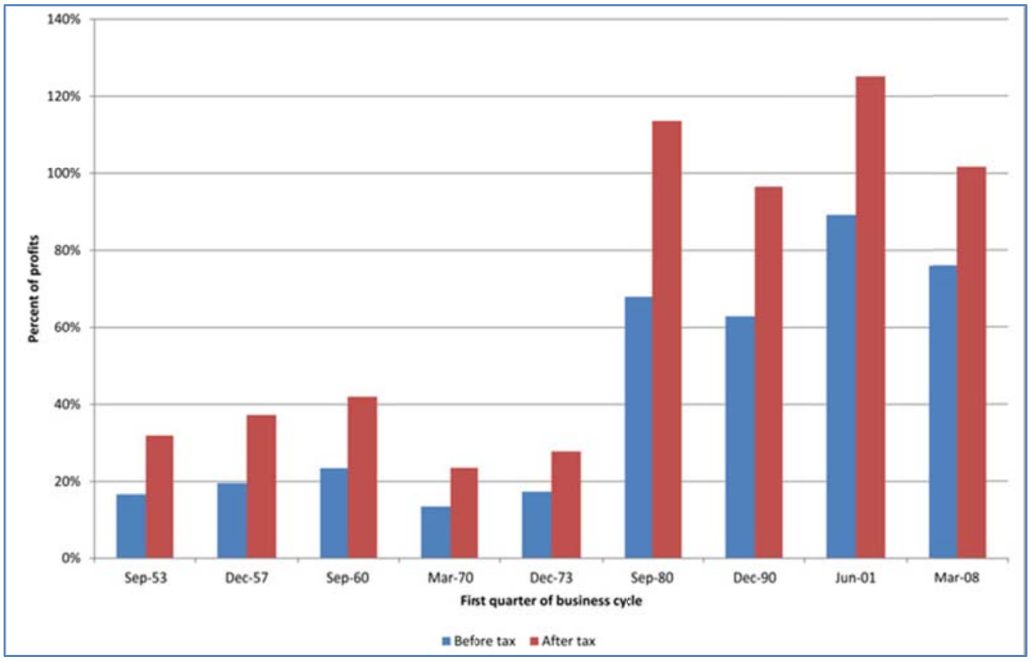
Source: Authors' calculations based on Board of Governors, Federal Reserve System 2010, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Companies have spent increasingly more of their profits on share purchases and dividend payouts to boost the value of stock prices. 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 instead 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.

Large share repurchases emerged starting in the 1980s. Companies distributed more cash to shareholders through this way 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.

FIGURE 4
Share Repurchases and Dividend Payouts as Share of Before and After Tax Profits, Business Cycle Averages



Source: 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.

The Short-Term, Speculative Bias in Corporate Governance

Corporate governance encompasses the institutions that are responsible for how a company allocates its resources. These institutions are the corporate executives, shareholders, and the board of directors. Managers, though, exercise a disproportionate amount of control over corporate resource allocations, as we discuss below.

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 carrots are performance-based compensation packages, such as stock options and stock grants, which 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. Management 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 case (Lazonick 2009). It was not until the 1970s that such 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 2010).

The pay-for-performance approach assumes that stock prices accurately reflect a company's performance. Research, though, shows that stock prices often follow fads, creating boom and bust cycles, rather than mirroring underlying economic fundamentals.[5]

Managers may thus be rewarded or punished for results that they have little control over. Hence, they have an incentive to influence share prices rather than actual corporate performance, which may not be the same thing. Share repurchases and dividend payouts can help to boost stock prices, while the link between investment and stock performance is less tangible.

On the contrary, corporate managers may pursue short-term profit-seeking activities, such as hollowing out the company's productive base, to generate funds for share repurchases and dividend payouts. Lazonick (2010) uses the term "downsize and distribute" to describe that a shrinking productive base mirrors growing efforts to directly boost share prices in the short run.

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 say 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 long-term productive investments. 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, Harvey, and Rajgopal 2004).

Performance-based executive 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 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 pay also often rewards executives even when they do not succeed. Of the CEOs whose companies' stock did not rise faster than Treasury bond yields, 16.5% 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 10% earned abnormal returns over the following five years of about –13.0% (Cooper, Gulen, and Rau 2010).

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. Shareholders could sue the company or wait until the annual shareholder meeting to make their disagreements with management known. They can also sell their shares or threaten to sell their shares (Gandhi 2010). Shareholders who want to remain engaged with a corporation can propose policy changes at a shareholder meeting, launch withholding vote campaigns, propose advisory shareholder votes, or vote against stock option plan. There are, however, limits to shareholder activism.

The Rise of the Institutional Investor

The most important change in the makeup of the corporate shareholder is 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 are heterogeneous. 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 2009a, 2009b). Mutual funds instead often turn over 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, and this 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, for instance, frequently demand that companies repurchase shares or pay out dividends. A 2008 study by April Klein and Emanuel Zur (2008) 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.

Several advantages allow hedge funds to exert an outsized influence on corporate decisions. First and foremost, they face a more favorable regulatory environment than longer-term investors do. 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 in their resource uses than is the case for longer-term institutional investors, such as pension plans and mutual funds (Klein and Zur 2009). 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 in the short term, their management has a personal stake in seeking short-term profits at target companies (Brav et al. 2008).

As a share of total trading, hedge funds are not significant, but as a share of shareholder activism, they wield much more influence over key management decisions. Hedge funds have waged several shareholder activism campaigns since 2000. They have removed underperforming managers, stopped mergers or acquisitions, and pressed for a company's sale. 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.[6] 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 (Conference Board 2009). Smaller institutional investors will follow, thus creating price swings and exacerbating losses.

One example of long-term institutional activism is the largest pension fund—the California Public Employee Retirement System (CalPERS). 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 further augmented its influence through the creation of the Council of Institutional Investors (CII), an influential shareholder organization that advocates on behalf of institutional investors with a long-term investment horizon (Smith 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, face public scrutiny that makes it difficult to pursue riskier campaigns that hedge funds can (Kahan and Rock 2007). And, mutual fund managers often list several reasons for their disengagement from shareholder activism, such as legal obstacles, contractual obligations, or lack of avid interest from shareholders, but most often they are simply unwilling to engage managers (Taub 2009a, 2009b).

The Limits of and Obstacles to Effective, Long-Term Shareholder Activism

Short-term institutional investors wield a disproportionate influence over corporate resource allocation decisions. This is in part a result of a temporal inconsistency with 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 ones (Gaspar, Massa, and Matos 2005). 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).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 the 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). Funds such as CalPERS have shown the possibility of activism by a long-term institutional investor, but the California institutional investor is also the biggest and best 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 has meant that it has remained a "minority pursuit" (O'Sullivan 2003).

Short-term institutional investors 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. Shareholders have difficulties 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 the 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, Brown, and Graffin 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.

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. The board of directors has, in practice, a much more complicated relationship with the corporate managers and the shareholders they are supposed to represent, often hampered by conflicts of interest and a lack of true accountability. This can lead to boards that often 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 who 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 decisions in their favor. Managers can curry favor with directors by influencing who gets on the board of directors, influencing the pay for the board of directors, or interacting with 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 CEOs 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, Murphy, and Wruck 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 and Weisman 2009). Even before these scandals, independent directors (individuals unaffiliated with the company prior to becoming a director) were becoming increasingly common. Even so, independent directors have not had a notable impact on long-term share value, executive compensation packages, or speculative investments (Gordon 2007).

The organization of the board matters for corporate governance decisions. There are two categories of boards—unitary boards and 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; e.g., 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 pursuing only a little of what shareholders are seeking (Bebchuk and Kamar 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 and Ferrell 2004).

Moving Toward Policy Reform

The issues outlined above foster an environment that puts into jeopardy the prospect of strong economic growth over the long term. 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 more innovative businesses. There are, however, several pathways to get there; e.g., through more 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; e.g., 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 at other performance metrics. These metrics could include spending on research and development; the level of capital expenditures for new ventures; the treatment of workers, specifically through investments in training and professional advancement; and customer satisfaction.

It has often been difficult to properly codify such long-term measures in the past. 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 recently enacted financial regulatory reform legislation—the Dodd–Frank Wall Street Reform and Consumer Protection Act—may be another important step in this direction. It 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 (Congressional Research Service 2010). This approach could be expanded to define long-term, productive practices, rather than just to prevent speculative ones. This regulation could also be broadened to apply to non-financial corporations. Such a broadening, though, also requires that policy makers identify the right regulatory agency since not all financial stability regulators (e.g., the Federal Reserve) have authority over non-financial 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. 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 seeking 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 corporate governance system suffers from flaws that 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.

Recent policy actions 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. The Dodd–Frank Wall Street Reform and Consumer Protection Act, for instance, legislates a variety of reforms aimed at curbing excessive executive pay through more transparency. Shareholders must have the opportunity to have a non-binding vote on executive compensation at least once every three years and 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 bill also attempts to establish a greater balance between management and shareholders. It requires, for example, that compensation committees are comprised of independent directors only and gives the committees the authority to hire outside consultants. The bill also 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 (Congressional Research Service 2010). Additional steps at the state and federal levels will be necessary to create a more balanced corporate governance system.

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 be overly emphasized on short-run profit seeking to the detriment of long-term investments.

One goal is thus to better identify long-term performance measures, and another goal is to find a better balance among key corporate governance players, specifically managers, short-term investors, long-term investors, and boards of directors.

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 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 managers and shareholders alike to think more long-term about performance and their investments. This means empowering all shareholders to be more effective activists, fixing the power deficit that exists between short-run institutional investors and long-term investors, and creating more incentives for longer-term corporate investments.

Endnotes

[1] Luke Reidenbach co-authored this paper while a research assistant at the Center for American Progress, Washington, DC. 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.

[2] A number of research studies have demonstrated the link between information technology investments and the productivity growth acceleration. See Brynjolfsson, McAfee, Sorrell, and Zhu (2007), Jorgenson, Ho, and Stiroh (2005, 2008), and Oliner, Sichel, and Stiroh (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 (U.S. Department of Commerce).

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

[6] 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.

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