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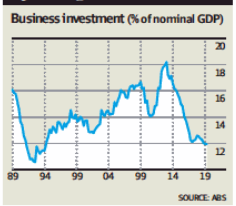
Want investment? Cut the burdens

THE AFR VIEW

Treasurer Josh Frydenberg wants a new investment wave to pick up where the mining and then housing booms left off – and to lift Australia over the threatening turbulence ahead as the China-US trade war deepens. Mr Frydenberg rightly says that growth is stalling because productivity is stalling. The business investment that would lift both has fallen dramatically, at its lowest as a percentage of the economy since the early 1990s. The Treasurer thinks that this is happening partly because companies won't back themselves. If they re-invested bigger surpluses, instead of showering investors with short-term rewards of special dividends and share buybacks – he says an exceptionally large figure of $29 billion went this way in the past year – then we would have a stronger economy.

Dividend growth has been flat for five years, but from the base of the historically highest payout ratios in the world. These are built into the tax system as the dividend imputation that the government spent the federal election defending from Labor grabs. The system has two healthy results. It provides Australian companies with lower-cost capital, reducing excessive reliance on debt. And strong dividend payouts are a discipline against wasteful expansion and poor investment decisions by managers. Indeed, half of the $29 billion that Mr Frydenberg cites was a chastened BHP repaying shareholders some of what the company burned on US shale energy. Yet BHP still manages to invest $US8 billion a year. On the other hand, Australia's home-grown but US-listed tech champion Atlassian makes little or no profit on a billion dollars or so of revenue. So it pays its Nasdaq shareholders few dividends, spending its money instead on product development to plough into future growth. Telstra does both, investing heavily in the technology race with other telco providers, but borrowing to pay dividends valued by local investors.

Spending cliff



Maybe this investment culture stops empire-building managers; and maybe it costs Australia those visionary investment long shots as well. But right now it is getting harder to find reasons to spend money rather than give it back to company owners in any form. It would be courageous for many to invest in the teeth of a Sino-US trade rift getting nastier by the week. And that's on top of the broader risks of digital disruption and competition from global supply chains. Countering these challenges of course means investing. But these days it could just as easily be in software or cloud services that politicians can't cut a ribbon to open. And not everyone is a CSL or Cochlear lionised by the Treasurer, in high-margin businesses, which can re-invest worldwide. Lower-margin businesses are being just as efficient when they give capital back to shareholders to decide.

Many fund managers will recoil at Australia's Treasurer urging company managers to risk more shareholder funds on risky ventures. On the other hand, many C-suite executives will welcome the call to invest in the long term rather than remain enslaved to short-term performance horizons. But the unifying message for owners and managers must surely be that the unnecessary handicaps on investing for growth need to be pared back. The political and chattering classes have used business as a punchbag for some years, culminating in the unleashing of litigate-first regulators on the banks, big-stick threats against energy suppliers, and bureaucrats deciding how executives are to be rewarded. Ironically, it has pushed companies into woolly introspection about whether or not they should be primarily driven by shareholder returns. Many have embraced worthy social and political causes that have bound them up in corporate red tape and box-ticking that has smothered the sort of clear-headed risk-taking needed to generate growth for all. Shareholder returns are not the only thing that matters. And looking after customers, employees and the communities in which companies operate should help build profits for the long haul. But, if an investment proposal does not offer a certain risk-adjusted rate of return, then shareholders can't be forced to invest. The biggest gains will come from removing the burdens that weigh on these returns to the detriment of shareholders, employees and the broader community alike.

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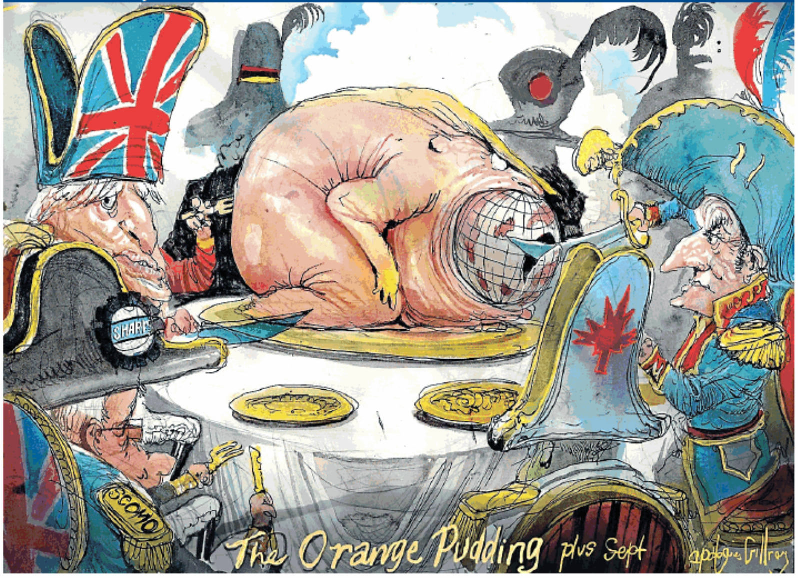
From the Gallery **David Rowe**



Business tax cut is a better signal

Economy

If the Treasurer wants more investment he can genuinely help by cutting the company tax rate, not perpetuating a myth about share buybacks.

Richard Holden

On Monday, Treasurer Josh Frydenberg told business leaders to stop sending their companies' profits back to shareholders and instead reinvest in their businesses.

"Share buybacks and capital returns are becoming increasingly prominent and the default option for corporates, but is a buyback always the best option for the future growth of the company and therefore the economy?"

Frydenberg, pictured, pointed to the "$29 billion ... returned to shareholders in the form of buybacks and special dividends, compared to an average of $12 billion over the previous four years".

As *The Australian Financial Review's* Chanticleer pointed out, $15.4 billion of that $29 billion was from BHP selling its US shale oil and gas assets, after a misguided and hugely costly series of investments in that sector. And therein lies the rub. Do we want our corporate chieftains risking our money – and thanks to compulsory superannuation it really is *our* money – with speculative and questionable investments, or returning it to the stockholders for them to use as they see fit?

Economic theory on this matter couldn't be clearer. The 2016 Nobel prize in economic sciences was shared by Bengt Holmstrom of MIT for his pioneering work on the so-called "principal-agent problem", where a principal hires an agent to work on her behalf and has to rely on various incentives to guide her actions, rather than directly controlling them.

In the corporate setting the principal is the shareholders (and their board of directors) and the agent is management. Management acting in the best interests of shareholders is evidence of corporate governance managing the tricky principal-agent problem in an effective way.

It is also worth dispelling a myth that share buybacks are a guaranteed benefit for shareholders – implicitly at the expense of employees. US presidential hopeful Elizabeth Warren has been madly attempting to puff new life into this fallacy, with her and other Democrats proposing limits on the amount of buybacks US companies can perform.

The "buyback fallacy" goes like this. A company uses cash on hand to buy back some of its stock from willing sellers. This reduces the number of shares outstanding, but the future earnings of the company are unchanged. So the earnings per share of stock go up, hence the stock price goes up. Simple, yes, but wrong. It

Frydenberg gets an A for diagnosis of the problem...but a much lower grade for his proposed solution.

misses the fact that the company had to use its own cash to repurchase the stock. This is a loss to the shareholders who don't sell. So the future value of the company is not unchanged. The key question is whether that cash was more valuable being reinvested by the company, or distributed to stockholders for other uses.

In the US we have seen companies such as Apple and Boeing – companies that have performed large buybacks – outperform the broader market. That's the market telling us that Apple and Boeing's cash was best used elsewhere.

One must have some sympathy for the Treasurer. He wants to get wages up for workers without some heavy-handed intervention through the Fair Work Commission. He correctly realises that companies investing more is what will lead to more jobs and higher wages. Frydenberg gets an A for diagnosis of the problem. But his proposed solution – using the bully pulpit to badger companies into acting contrary to the interests of their shareholders – is worthy of a much lower grade.

Businesses invest when economic conditions make it attractive to do so. Right now, the global economy is in turmoil. Europe continues to be a low-growth basket case; Brexit looms in Britain; the US economy is in trouble and the Fed is cutting rates; and the President of the United States has embarked upon a disastrous trade war with China. Domestic conditions aren't great either, with growth slowing and the Reserve Bank governor pointing out at every available opportunity that his policy instruments are running out of steam.

If the Treasurer wants Australian businesses to invest more, he needs to do what he can to make investment more attractive. Cutting the company tax rate for all companies to 25 per cent immediately would be a good start. It would begin to get our company tax rate down from being one of the highest in the OECD – a rate that makes investment in Australia less attractive than investing abroad.

Not only would this boost investment, the best international evidence is that about half the benefit of corporate tax cuts goes to workers. And as I wrote last year, that same evidence indicates young, low-skilled and female workers benefit the most.

And as I have said for more than four years, we need major investments in physical and social infrastructure to deal with flagging demand, and hence lower corporate investment.

These fixes are not hard to execute, and they will do a lot more to boost investment than berating the Business Council of Australia. But they will require this government – and the Labor opposition – to jettison their balanced-budget fetishism that is spectacularly ill suited to the precarious economic moment in which we find ourselves.

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