Opinions

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High Profit Margins but Low Business Investment: Can Businesses Be Taxed To Invest?

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Large business groups in Korea are sitting on a pile of cash surplus! This news came as a surprise to a nation that has been through economic hardship. In the first quarter of 2015, the combined retained earnings of the 30 largest business groups in Korea reached 710 trillion Korean won, the equivalent of roughly 617 billion US dollars. The top 5 business groups alone are holding 502 trillion won, or 436 billion dollars. This is a 5.7 percent increase from a year ago. To put these numbers into perspective, the iconic company of our time, Apple, reportedly has 194 billion dollars in cash.

Why not use the money to invest and create jobs? One could naturally wonder. Critics of Korean business groups view this phenomenon as a sign of injustice, and demand a raise of the corporate tax rate, which is currently 22 percent. The Korean government unveiled plans to introduce a temporary tax on retained earnings, hoping to incentivize businesses to use their booming profits to invest.

The popular image that corporations are sitting on a mountain of cash is partially misleading because the retained earnings do not necessarily mean that companies have plenty of idle cash. A part of those earnings are put to use in the form of inventories, machineries, lands, or share holdings in other companies.

But critics have their point. The money can be and perhaps should be better spent. It can generate a virtuous circle for the economy if it is used to hire more workers and newer investment goods. What is behind the national sentiment is the frustration coming from the recognition that leading business groups failed to invest and failed to create quality jobs.

It is hard to miss the irony here. In 1997, when the country was in economic turmoil, over-investment, or better put inefficient investment, was viewed as a cause of the crisis. The same business conglomerates were accused of making haphazard and wasteful investment decisions fueled by cheap subsidized credit. The investment glut has become an investment shortage. This is indeed a significant change in just less than 20 years.

Since the 1997 economic crisis, the ratio of gross investment to GDP has steadily dropped. During the investment glut, from the late 1980s to the eve of the 1997 crisis, the ratio was as high as 40 percent. It then dropped sharply because of the crisis, but steadily increased since then and stayed stable at 30%. It took the 2008 global financial crisis to make another dent in the trend, which is appearing to resume its downward slide, although it is too early to tell if this trend is here to stay for the long term.

The other side of the coin is the savings rate trend. Korea used to be characterized as a country ever hungry for funding. The savings ratio, gross savings of GDP, has been steadily dropping but the rate of decline was not as sharp as the investment ratio. As a result, Korea holds a savings surplus where the savings ratio has been consistently higher than the investment ratio. The gap stays as high as 4.5 percent. The remarkable fact is that the corporate sector contributes the most to the trend and has the highest savings rate, compared to households or government. Since savings simply indicates the difference between what you earned and what you spent, high corporate savings can be interpreted as an improved profit margin.

This leads us back to the previous question. Why do companies earn fat profits but do not invest accordingly? And if socially desirable, can the government tax corporations to invest?

It may be useful to point out that low business investment and high profit margins are an experience shared by other countries. Andrew Smithers (2013) convincingly argues that in the leading five economies, the G5, corporate profits accounted for the highest share of GDP but business investment has been remarkably weak. He argues that the decline in business investment cannot be explained by weak confidence or the declining returns on capital, but instead by the way that management is paid.

More and more CEOs in developed economies are getting paid in the form of bonuses and stock options rather than salaries. The bonuses are often tied to stock prices. Buy-backs or paying dividends often help to boost stock prices, but investment plans may not. To support his claim, Smithers shows that US companies are getting generous with paying out their cash to shareholders. They invested fifteen times as much as they distributed to shareholders in the 1970s, but the ratio has recently dropped to below twice.

Much of Smithers' discussions seem applicable to Korea, but the argument that how management gets paid explains low investment does not appear to hold. It is because of the unique ownership structure of Korean business groups. Many large conglomerates are still controlled by families who typically own a fraction of total shares but somehow keep the controlling power. This separation of ownership and cash flow creates an incentive that discourages paying out dividends. Simply put, family-owners that make decisions do not gain much personal benefit from dividends.

In fact, the Korean corporate sector has been and still is stingy with paying out dividends. The ratio of dividend payout over profits is on the low side compared to other developed or developing countries. Moreover, the dividend payout ratio has dropped since 2008. It was 27.1 percent in 2008, but fell to 22.6 percent in 2013.

If management style cannot explain low investment, then what can? One theory is that new investment opportunities are rare. But there seems to be little evidence to show that return on investment has recently been low. In fact, the very fact that retained earnings are rapidly increasing indicates that the opposite has been true. There are also empirical studies showing that profit margins and business investment are only loosely connected.

Another theory emphasizes the role of uncertainty. After the 2008 financial crisis, uncertainty has spiked and companies have become risk averse. One such indication is deleveraging, or the reduction of corporate debt. As a matter of fact, deleveraging in Korea is still underway. The ratio of business' financial debt to GDP was down to 105 percent in the second quarter of 2014 from 166 percent in 2004.

If uncertainty and risk-aversion explain the current low investment rates, it is not an advisable step for the government to use tax to encourage investment. It would only create distortions, if the current business decisions reflect new economic realities.

It is helpful to know that Korea had a corporate tax similar to what is now being discussed. From 1991 to 2001, there was a tax on excess retained earnings. But it was a protective measure for small shareholders from family owners who wanted to keep profits within their companies. The purpose of the tax was to encourage dividends, not investment. The new tax, if implemented as planned, may not achieve its purpose, boosting investment, although it may encourage the payment of dividends.

Reformers in Korea have believed that restructuring corporate ownership, moving powers from family owners to professional managers, will do much good, making corporations more socially responsible and perhaps creating more jobs. But drawing from what Smithers discussed on advanced economies, it appears that even under the new regime, under the stewardship of professional managers, we may get stuck with the same problem. Low investment and the lack of job creation may stay with us, although the cause of such problems may differ. This is, perhaps, the irony of our time.