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How Corporations Subsidize the Federal Debt

The exploding federal debt motivated the Fed's low interest rate and liquidity policies which, inadvertently, have penalized corporations.

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As the United States approaches $20 trillion in debt, our nation's leadership has maintained low interest rates, which keep the annual federal government budget deficit from ballooning even further out of control. The 30-year U.S. bond yield is 2.9% at this writing, which is over 5% lower than it was at the start of 1990. Rates have dropped further at shorter maturities.

If the government had to pay 5% more on $20 trillion in debt, that would add $1 trillion to the annual deficit. The accommodative interest rate and liquidity policies of the Federal Reserve are supposed to encourage more corporate investment, faster economic growth, and quicker job creation. But the Fed was also motivated to reduce the interest cost on the exploding federal debt.

In November 2008 the effective Federal Funds Rate moved below 0.5%, lower than the prior 50 years, and it stayed below 0.5% ever since. Starting that same month, the Fed purchased trillions in U.S. Treasury and agency debt, in a policy known as "quantitative easing," which flooded the market with liquidity.

Has the corporate investment rate increased? We examined the non-financial members of the S&P 500 with data from 2008 to 2015. Total capital expenditures plus R&D outlays in 2015 were 45% of EBITDAR, or earnings before interest, taxes, depreciation, amortization and R&D, which is the same as 2008. Companies are not investing any more of their cash flow, which is an important reason why we are experiencing a slow economic recovery.

There are two factors that combine to constrain investment. First, low interest rates tend to make assets more expensive. Consider how low mortgage rates drive up housing prices, a phenomenon that affects many asset classes.

Second, most companies have not reduced their investment hurdle rates because they believe low interest rates are temporary, and they want to avoid investments that will underperform when interest rates rise. This may not be consistent with corporate finance theory, but it is happening nonetheless. The high asset prices and inflated hurdle rates combine to make investments appear less valuable, which limits the volume of investments.

Despite the leverage fears of 2008, the "cheap debt" environment has led the companies we studied to increase net debt almost 50% from $2.2 trillion in 2008 to $3.2 trillion in 2015. This incremental financing wasn't used to fund investment in growth, as we saw above. Instead companies increased the sum of dividends and net stock buybacks by 86%. From 2008 to 2015 these distributions rose from 27% to 39% of EBITDAR. Our research shows that companies with above-industry-average leverage tend to grow slower. Thus, this exchange of debt for equity is another way the national debt induced Fed policy has constrained growth.

Low interest rates also adversely affect pension math. For companies with defined- benefit pension plans, low interest rates tend to reduce pension asset growth and inflate the present value of pension benefit obligations, which can make a pension plan seem more underfunded than it would be in a normalized interest rate environment. The Pension Benefit Guarantee Corporation charged 0.9% on unfunded pension liabilities in 2013, but this increased to 3.4% for 2017. For companies that still offer these benefits, this "back door tax" makes employees more expensive and may discourage corporate job growth.

Although the Fed directly controls short-term interest rates, its policies have brought down long-term rates and have reduced inflation expectations. We certainly wouldn't want a return to 1970's-like double digit inflation, but near zero inflation isn't good for corporations either. With a modest 2% to 4% inflation rate, companies have more flexibility in controlling costs. Nobody likes having his or her salary reduced, which today makes it hard for companies to reduce salary expense without eliminating jobs. With modest inflation, companies can slow salary growth when needed to reduce the real cost of salaries without eliminating jobs. The last two years have had CPI inflation rates below 1% so this flexibility is gone.

With our national debt setting new records almost every day, it may be unlikely the Fed will meaningfully raise interest rates without unprecedented federal cost cutting. So for the foreseeable future, we are likely to continue to see mediocre corporate investment rates, increases in leverage and back-door taxes on pension plans. The harm this does to corporate America is effectively a subsidy of the ballooning federal debt.

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