

Social Capital, Corporate Purpose and the Revival of American Capitalism

Steven Pearlstein

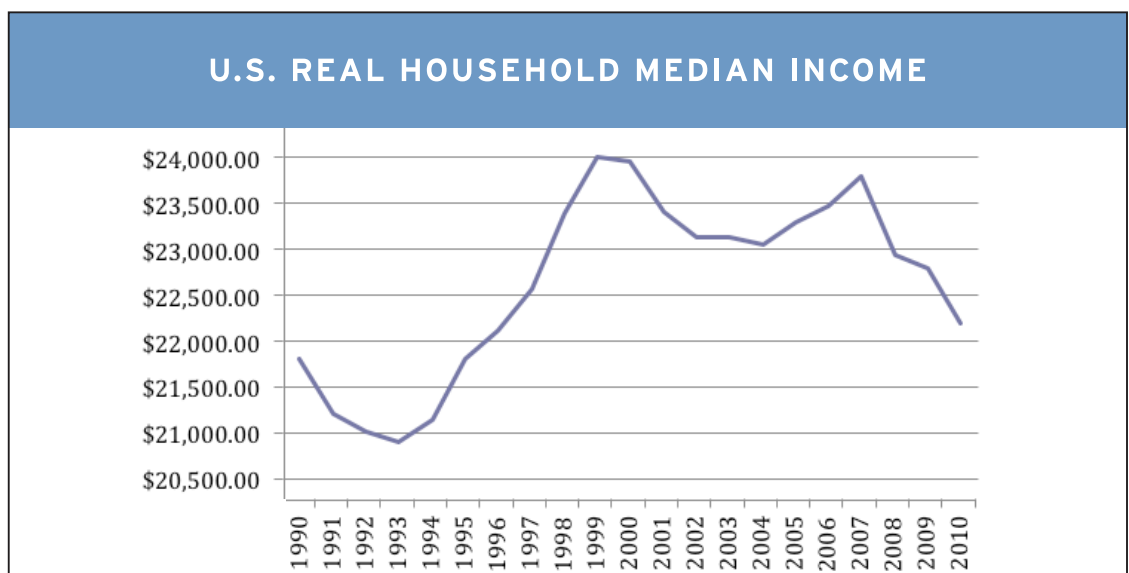
INTRODUCTION



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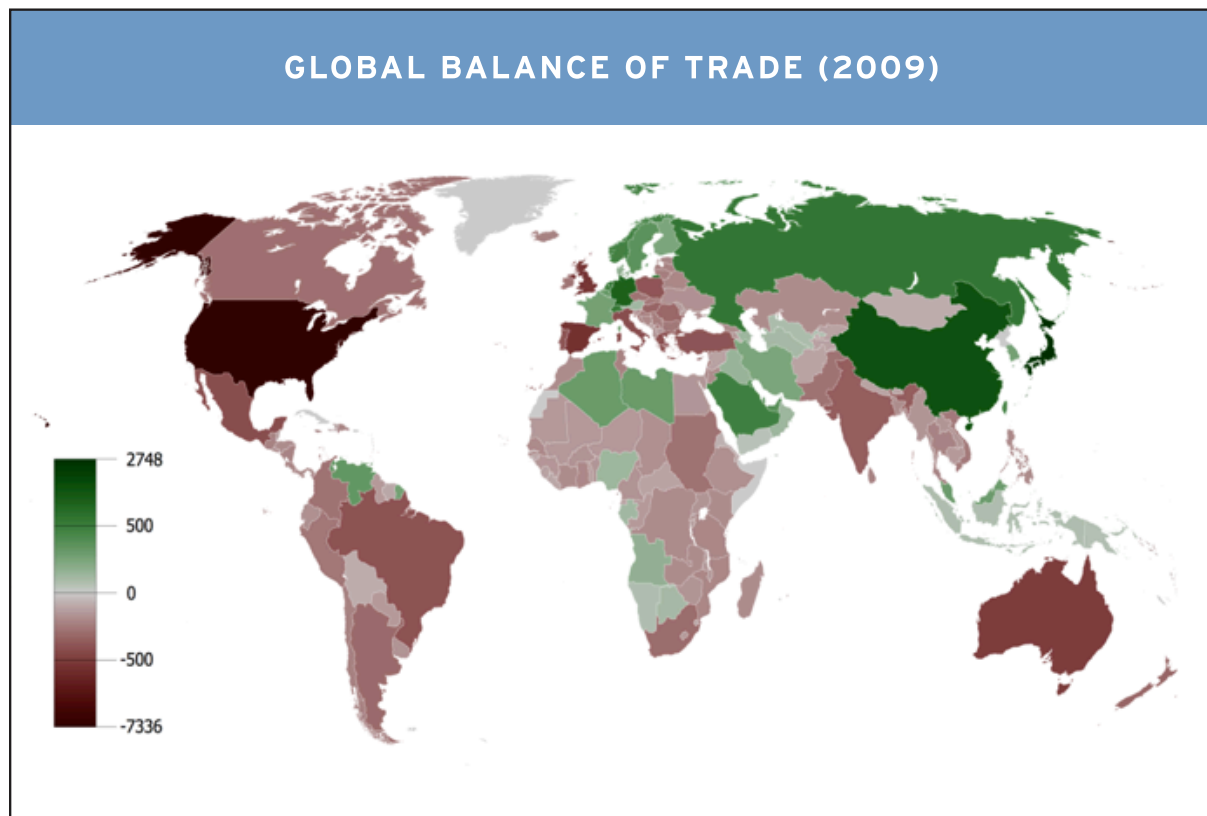
It was only twenty years ago that the world was in the thrall of American-style capitalism. Not only had it vanquished communism, but it was widening its lead over Japan Inc. and European-style socialism. American companies were widely viewed as the most innovative and productive, its capital markets the most efficient, its labor markets the most flexible and meritocratic, its product markets the most open and competitive, its tax and regulatory regimes the most accommodating to economic growth.

Today, that sense of confidence and economic hegemony seems a distant memory. We have watched the bursting of two financial bubbles, struggled through two long recessions and suffered a lost decade in terms of incomes of average American households (since 2000).



Source: Median income data from the U.S. Census Bureau and CPI data from the Bureau of Labor Statistics

We continue to rack up large trade deficits even as many of the country's biggest corporations shift more of their activity and investment overseas.¹ Economic growth has slowed, and whatever productivity gains there have been have been captured by the top 10 percent of households.² Economic mobility has declined to the point that, by international comparison, it is only middling.³ A series of accounting and financial scandals, coupled with ever-escalating pay for chief executives and hedge fund managers, has generated widespread cynicism about business. Other countries are beginning to turn to China, Germany, Sweden and even Israel as models for their economies.



Source: IMF World Economic Outlook Database, 2009. <http://www.imf.org/external/pubs/ft/weo/2009/01/weodata/index.aspx>

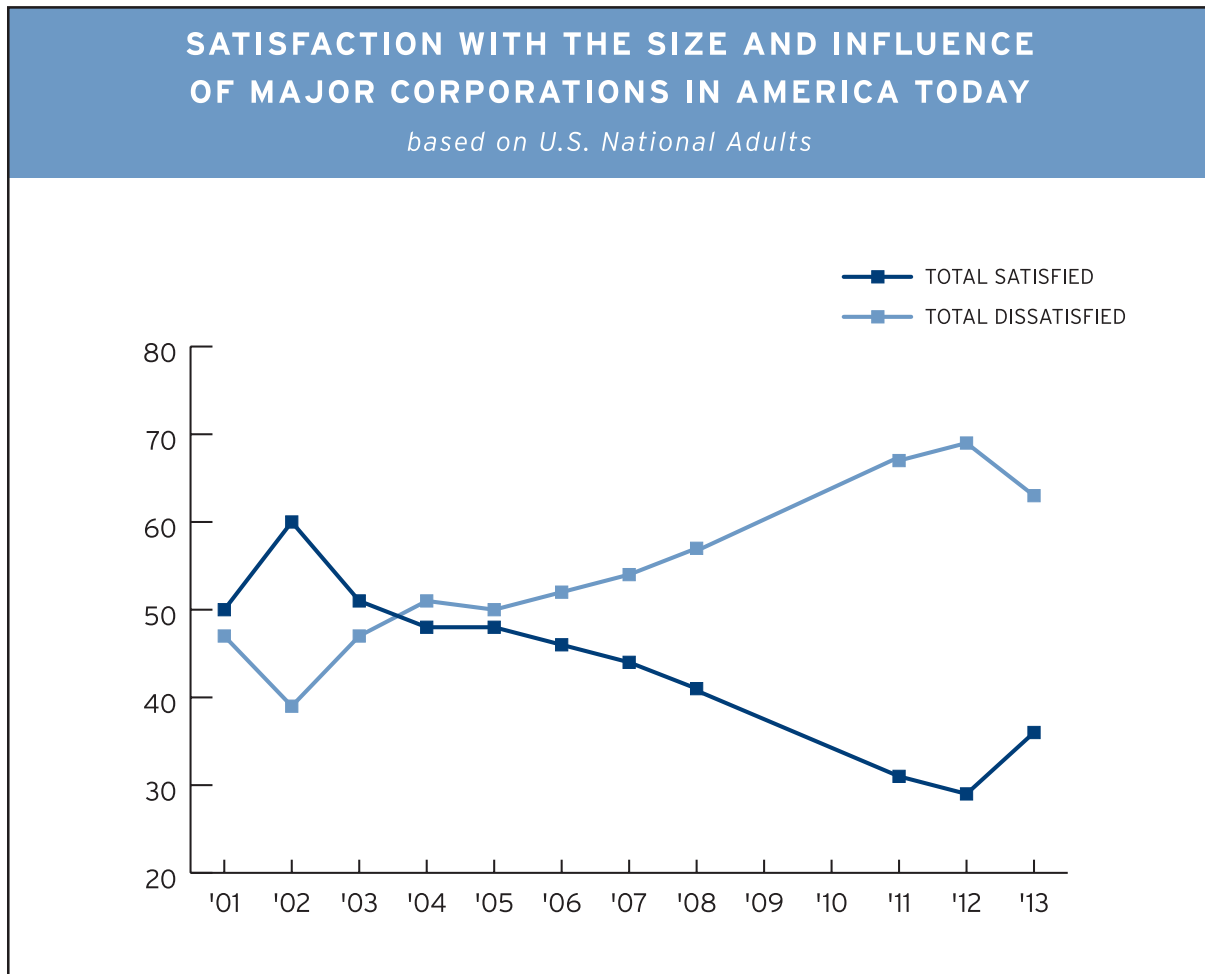
No wonder, then, that large numbers of Americans have begun to question the superiority of our brand of free-market capitalism. This disillusionment is reflected in public opinion polls, in the rise of the Tea Party and the Occupy Wall Street movements, and the increasing

1 James K. Jackson, "U.S. Direct Investment Abroad: Trends and Current Issues," Congressional Research Service Report, October 26, 2012, <http://www.fas.org/sgp/crs/misc/RS21118.pdf>

2 "State of Working America," Economic Policy Institute, 2008. <http://www.stateofworkingamerica.org/who-gains/#/?start=1975&end=2008>; and "Econobites," The Roosevelt Institute, September 11, 2012. <http://www.rooseveltinstitute.org/econobytes-tuesday-september-11-2012>

3 "Does America Promote Mobility as Well as Other Nations?" Economic Mobility Project, *The Pew Charitable Trusts*, [http://www.pewstates.org/uploadedFiles/PCS_Assets/2011/CRITA_FINAL\(1\).pdf](http://www.pewstates.org/uploadedFiles/PCS_Assets/2011/CRITA_FINAL(1).pdf)

polarization of our national politics.⁴ It is also reflected in the pages of the mainstream media⁵, the shelves of bookstores⁶ and on the screens of movie theaters.⁷



Source: Gallup Poll Social Series: Mood of the Nation, January 7-10, 2013. Available online here: <http://www.gallup.com/poll/159875/americans-similarly-dissatisfied-corporations-gov.aspx>

Embedded in these critiques is not simply a collective disappointment in the inability of American capitalism to deliver on its economic promise of income, wealth and employment

4 "Capitalism's waning popularity: A global poll shows an ideology in apparent decline," *The Economist*, April 7th, 2011 <http://www.economist.com/node/18527446>

5 See the *New York Times* recurring opinion series entitled "The Great Divide," which can be found online at <http://opinionator.blogs.nytimes.com/category/the-great-divide/>

6 Among recent books are *Plutocrats* by Chrystia Freeland; *What Money Can't Buy* by Michael J. Sandel; *A Capitalism for the People* by Luigi Zingales; *How Much Is Enough* by Robert and Edward Skidelsky; *Fixing the Game* by Roger Martin; *The Price of Inequality* by Joseph Stiglitz; *Who Stole the American Dream* by Hendrik Smith; *Average is Over* by Tyler Cowen; *The Corruption of American Capitalism* by David Stockman; *The Big Short* by Michael Lewis

7 Recent movies on this subject include *Wall Street: Money Never Sleeps*; *Inequality for All*; *Inside Job*; *Too Big to Fail*; *Margin Call*; *The Queen of Versailles*; *The Wolf of Wall Street*

opportunity. Running through them is also a nagging question about the larger purpose of the market economy and how it serves society.

In the current, cramped model of American capitalism, with its focus on maximizing output growth and shareholder value, there is ample recognition of the importance of financial capital, human capital and physical capital, but no consideration of social capital. Social capital is the trust we have in one another, and the sense of mutual responsibility for one another, that gives us the comfort to take risks, make long-term investments, and accept the inevitable dislocations caused by the economic gales of creative destruction. Social capital provides the necessary grease for increasingly complex machinery of capitalism, and for the increasingly contentious machinery of democracy. Without it, democratic capitalism cannot survive.

It is our social capital that is now badly depleted. This erosion manifests itself in the weakened norms of behavior that once restrained the most selfish impulses of economic actors and provided an ethical basis for modern capitalism. A capitalism in which Wall Street bankers and traders think it is just “part of the game” to peddle dangerous loans or worthless securities to unsuspecting customers, a capitalism in which top executives have convinced themselves that it is economically necessary that they earn 350 times what their front-line workers do, a capitalism that thinks of employees as expendable inputs, a capitalism in which corporations perceive it as both their fiduciary duty to evade taxes and their constitutional right to use unlimited amounts of corporate funds to purchase control of the political system—that is a capitalism whose trust deficit is every bit as corrosive as budget and trade deficits.

As economist Luigi Zingales of the University of Chicago concluded in his recent book, “A Capitalism for the People,” American capitalism has become a victim of its own success.⁸ In the years after the demise of communism, “the intellectual hegemony of capitalism led to complacency and extremism: complacency through the degeneration of the system, extremism in the application of its ideological premises,” he writes “‘Greed is good’ became the norm rather than the frowned-upon exception. Capitalism lost its moral higher ground.”

Pope Francis recently gave voice to this nagging sense that our free market system had lost its moral bearings. “Some people continue to defend trickle-down theories which assume that economic growth, encouraged by a free market, will inevitably succeed in bringing about greater justice and inclusiveness in the world,” wrote the new pope in an 84-page Apostolic Exhortation. “This opinion, which has never been confirmed by the facts, expresses a crude and naïve trust in the goodness of those wielding economic power and in the sacralized workings of the prevailing economic system.”⁹

8 Luigi Zingales, *A Capitalism for the People*, Basic Books: New York, June 5, 2012.

9 “The Joy of the Gospel,” Apostolic Exhortation of Pope Francis, Vatican Press, 2013

Our challenge now is to restore both the economic and moral legitimacy of American capitalism. And there is no better place to start than with a reconsideration of the purpose of the corporation.

“MAXIMIZING SHAREHOLDER VALUE”

In the recent history of bad ideas, few have had a more pernicious effect than the one that corporations should be managed to maximize “shareholder value.”

Indeed, much of what we all perceive to be wrong with the American economy these days—the slowing growth and rising inequality, the recurring scandals and wild swings from boom to bust, the inadequate investment in R&D, worker training and public goods—all of these have their roots in this misguided ideology.

It is an ideology, moreover, that has no basis in history, in law, or in logic. What began in the 1970s and 80s as a useful corrective to self-satisfied managerial mediocrity has become a corrupting self-interested dogma peddled by finance professors, Wall Street money managers and over-compensated corporate executives.

Let’s start with the history. The earliest corporations, in fact, were generally chartered not for private but for public purposes, such as building canals or transit systems. And well into the 1960s, corporations were widely viewed as owing something in return to the community that provided them with special legal protections and the economic ecosystem in which they could grow and thrive.

Legally, there are no statutes requiring companies be run to maximize profits or share prices. In most states, corporations can be formed for any lawful purpose. Lynn Stout, the Cornell law professor, has been looking for years for a corporate charter that even mentions maximizing profits or share price. So far, she hasn’t found one. Companies that put shareholders at the top of their hierarchy do so by choice, writes Stout, not by law.¹⁰

Nor does the law require, as many believe, that executives and directors owe a special fiduciary duty to the shareholders who own the corporation. The director’s fiduciary duty, in fact, is owed simply to the corporation, which is owned by no one, just as you and I are owned by no one—we are all “persons” in the eyes of the law. Corporations own themselves.¹¹

¹⁰ Lynn Stout, *The Shareholder Value Myth*, Berrett-Koehler: San Francisco, CA, May 7, 2012. Additional support for this legal interpretation can be found in Hansmann, Henry and Pargendler, Mariana, *The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption* (February 15, 2013). ECGI - Law Working Paper No. 219. <http://ssrn.com/abstract=2219865>

¹¹ Ibid.

What shareholders possess is a contractual claim to the “residual value” of the corporation once all its other obligations have been satisfied—and even then the directors are given wide latitude to make whatever use of that residual value they choose, just as long they’re not stealing it for themselves.¹²

It is true, of course, that only shareholders have the power to elect the corporate directors. But given that in almost all instances directors are nominated by the management and current board and run unopposed, it requires the peculiar imagination of corporate counsel to leap from the shareholder’s power to “elect” directors to a sweeping mandate that directors and the executives must put the interests of shareholders above all others.

Given this lack of legal or historical support, it is curious how “maximizing shareholder value” has evolved into such a widely accepted norm of corporate behavior.

Milton Friedman, the University of Chicago free-market economist, is often credited with first articulating the idea in a 1970 essay for the *New York Times Magazine* in which he argued that “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits....” Anything else, he argues, is “unadulterated socialism.”¹³

A decade later, Friedman’s was still a minority view among corporate leaders. In 1981, as Ralph Gomory and Richard Sylla recount in a recent article in *Daedalus*, the Business Roundtable, representing the nation’s largest firms, issued a statement recognizing a broader purpose of the corporation.¹⁴

“Corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs and build the economy.” The statement went on to talk about a “symbiotic relationship” between business and society not unlike that voiced nearly 30 years earlier by General Motors chief executive Charlie Wilson, when he famously told a Senate committee that “what is good for the country is good for General Motors, and vice versa.”

By 1997, however, the Business Roundtable was striking a tone that sounded a whole lot more like Professor Friedman than CEO Wilson. “[T]he principal objective of a business enterprise is to generate economic returns to its owners....” it declared in its statement on corporate

12 Ibid.

13 Friedman’s article from *The New York Times Magazine*, September 13, 1970, entitled “The Social Responsibility of a Business is to Increase its Profits” can be found reprinted online here: <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>

14 Ralph Gomory and Richard Sylla, “The American Corporation,” *Daedalus*, Vol. 142, Issue 2, Spring 2013.

responsibility. “[I]f the CEO and the directors are not focused on shareholder value, it may be less likely the corporation will realize that value.”

The most likely explanation for this transformation involves three broad structural changes that were going on in the US economy—globalization, deregulation and rapid technological change. Over a number of decades, these three forces have conspired to rob what were once the dominant American corporations of the competitive advantages they had during the “golden era” of the 1950s and 1960s in both U.S. and global markets. Those advantages—and the operating profits they generated—were so great that they could spread the benefits around to all corporate stakeholders. The post-war prosperity was so widely shared that it rarely occurred to stockholders, consumers, or communities to wonder if they were being shortchanged.

It was only when competition from foreign suppliers or newly-deregulated upstarts began to squeeze out those profits—often with the help of new technologies—that these once mighty corporations were forced to make difficult choices. In the early going, their executives found that it was easier to disappoint shareholders than customers, workers or even their communities. The result, during the 1970s, was a lost decade for investors.¹⁵

Beginning in the mid-1980s, however, a number of companies with lagging stock prices found themselves targets for hostile takeovers launched by rival companies or corporate raiders employing newfangled “junk bonds” to finance unsolicited bids. Disappointed shareholders were only too willing to sell out to the raiders. And so it developed that the mere threat of a hostile takeover was sufficient to force executives and directors across the corporate landscape to embrace a focus on profits and share prices. Almost overnight they tossed aside their more complacent and paternalistic management style, and with it a host of old inhibitions against laying off workers, cutting wages and benefits, closing plants, spinning off divisions, taking on debt, moving production overseas. Some even joined in making hostile takeovers themselves.

Spurred on by this new “market for corporate control,” the era of managerial capitalism soon gave way to the era of shareholder capitalism, which continues to this day. Those high-yield bonds, once labeled as “junk” and peddled by upstart and ethically-challenged investment banks, are now a large, established and profitable part of the business of every Wall Street firm. The unsavory raiders have now morphed into respected billionaire private equity and hedge fund managers, some of whom proudly call themselves “activist investors.” And corporate executives who once arrogantly ignored the demands of Wall Street now profess they have no choice but to dance to its tune.

¹⁵ The S&P 500 Index, a commonly used measure of the performance of U.S. equity markets, had a net decline of nearly 11 points from 118.05 in 1971 to 107.48 in 1979. (<http://www.standard.com/annuities/eforms/13038.pdf>).

THE INSTITUTIONAL INFRASTRUCTURE SUPPORTING SHAREHOLDER VALUE

An elaborate institutional infrastructure has now developed to reinforce shareholder capitalism and its widely-accepted corporate mandate to maximize short-term profits and share price. This infrastructure includes free-market oriented think tanks and university faculties that continue to spin out elaborate theories about the efficiency of financial markets.

An earlier generation of economists had looked at the stock market boom and bust that led to the Great Depression and concluded that share prices often reflected irrational herd behavior on the part of investors. But in the 1960s, a different theory began to take hold at intellectual strongholds such as the University of Chicago that quickly spread to other economics departments and business schools. The essence of the “efficient market hypothesis,” first articulated by Eugene Fama (a 2013 Nobel laureate) is that the current stock price reflects all the public and private information known about a company, and therefore is a reliable gauge of the company’s true economic value. For a generation of finance professors, it was only a short logical leap from this hypothesis to a broader conclusion that the share price is therefore the best metric around which to organize a company’s strategy and measure its success.

With the rise of behavioral economics, and the onset of two stock market bubbles, the efficient market hypothesis has more recently come under serious criticism. Another of this year’s Nobel winners, Robert Shiller, demonstrated the various ways in which financial markets are predictably irrational.¹⁶ Curiously, however, the efficient market hypothesis is still widely accepted by business schools—and, in particular, their finance departments—which continue to preach the shareholder-first ideology.

Surveys by the Aspen Institute’s Center for Business Education, for example, find that most MBA students believe that maximizing value for shareholders is the most important responsibility of a company, and that this conviction strengthens as they proceed toward their degree, in many schools taking courses that teach techniques for manipulating short-term earnings and share prices.¹⁷ The assumption is so entrenched that even business school deans who have publicly rejected the ideology acknowledge privately that they’ve given up trying to convince their faculties to take a more balanced approach.

Equally important in sustaining the shareholder focus are corporate lawyers, in house as well as outside counsel, who now reflexively advise companies against actions that would predictably lower a company’s stock price.

¹⁶ Robert Shiller, *Irrational Exuberance*, Crown Business; 2 edition, May 9, 2006.

¹⁷ The Aspen Institute Center for Business Education, “Where Will They Lead?: MBA Student Attitudes about Business and Society,” 2008. The findings of the study can be accessed online here: http://www.aspeninstitute.org/sites/default/files/content/docs/bsp/SAS_PRINT_FINAL.PDF.

For many years, much of the jurisprudence coming out of the Delaware courts—where most big corporations have their legal home—was based around the “business judgment rule,” which held that corporate directors have wide discretion in determining a firm’s goals and strategies, even if their decisions have the effect of reducing profits or share prices.

But in 1986, the Delaware Court of Chancery ruled that directors of Revlon, the cosmetics company, had to put the interests of shareholders first and accept the highest price offered for the company. As Lynn Stout has written, and the Delaware courts subsequently confirmed, the decision was a narrowly-drawn exception to the business judgment rule which only applies once a company has decided to put itself up for sale. But it has been widely—and mistakenly—used ever since as a legal rationale for the primacy of shareholder interests and the legitimacy of share price maximization.¹⁸

Reinforcing this mistaken belief are the shareholder lawsuits that are now routinely filed against public companies by class action lawyers any time the stock price takes a sudden dive. Most of these are frivolous and, particularly since passage of reform legislation in 1995, most are dismissed. But even those that are dismissed generate cost and hassle, while the few that go to trial risk exposing the company to significant embarrassment, damages and legal fees.

The bigger damage from these lawsuits is in the subtle way they affect corporate behavior. Corporate lawyers, like many of their clients, crave certainty when it comes to legal matters. So they’ve developed what might be described as a “safe harbor mentality”—an undue reliance on well-established bright lines in advising clients to shy away from actions that might cause the stock price to fall and open the company up to a shareholder lawsuit. Such actions include making costly long-term investments, or admitting mistakes, or failing to follow the same ruthless strategies toward workers, customers or communities as competitors. One effect of this “safe harbor mentality” is to reinforce the focus on short-term share price.

The most extensive infrastructure supporting the shareholder value ideology is to be found on Wall Street, which remains thoroughly fixated on quarterly earnings, quarterly investment returns and short-term trading. Companies that refuse to give quarterly earnings guidance are systematically shunned by some money managers,¹⁹ while those that miss their earnings targets by even small amounts see their stock prices hammered.²⁰

18 Lynn Stout, “The Problem of Corporate Purpose,” *Issues in Government Studies*, Number 48, June 2012.

19 A study by McKinsey & Company cites several examples of publicly traded companies that have either stopped producing quarterly earnings reports or diminished their focus on short-term financial measurements including Google, CitiGroup, Motorola, and Intel. The report attributes a 7 percent decline in Google’s value in February 2006 to exuberant expectations influenced by Google’s lack of earnings guidance for investors (http://www.mckinsey.com/insights/corporate_finance/the_misguided_practice_of_earnings_guidance).

20 In January 2013, after an announcement the Apple Computers would miss its earnings projection, the company saw its stock price slip 10 percent in after-hours trading (http://articles.washingtonpost.com/2013-01-23/business/36497081_1_iphones-ramon-llamas-chief-executive-tim-cook).

Recent investigations into insider trading have revealed the elaborate strategies and tactics used by some hedge funds to get advance information about a quarterly earnings report in order to turn enormous profits by trading on it.²¹ And corporate executives continue to spend enormous amounts of time and attention on industry analysts whose forecasts and ratings continue to have tremendous impact on share prices.

In a now infamous press interview in the summer of 2007, former Citigroup chairman Charles Prince provided a window into the hold that Wall Street has over corporate behavior. At the time, Citi's share price had lagged behind that of the other big banks, and there was speculation in the financial press that Prince would be fired if he didn't quickly find a way to catch up. In the interview with the *Financial Times*, Prince seemed to confirm that speculation. When asked why he was continuing to make loans for high-priced corporate takeovers despite evidence that the takeover boom was losing steam, he basically said he had no choice—as long as other banks were making big profits from such loans, Wall Street would force him, or anyone else in his job, to make them as well. “As long as the music is playing,” Prince explained, “you’ve got to get up and dance.”²²

It isn't simply the stick of losing your job, however, that causes corporate executives to focus on maximizing shareholder value. There are also plenty of carrots to be found in those generous—some would say gluttonous—pay packages whose value is closely tied to the short-term performance of company stock.

The idea of loading up executives with stock options also dates to the transition to shareholder capitalism. The academic critique of managerial capitalism was that the lagging performance of big corporations was a manifestation of what economists call an “agent-principal problem.”²³ In this case the “principals” were the shareholders and their directors and the misbehaving “agents” were the executives who were spending too much of their time, and the shareholder's money, worrying about employees, customers and the community at large.

In what came to be one of the most widely-cited academic papers of all time, business school professors Michael Jensen of Harvard and William Meckling of the University of Rochester wrote in 1976 that the best way to align the interests of managers to those of the shareholders was to tie a substantial amount of the managers' compensation to the share price.²⁴ In a

21 For more information on these topics see Anita Raghavan, *The Billionaire's Apprentice*, Business Plus: New York, June 4, 2013 and Ben Protess and Peter Lattman, “After a Decade, SAC Capital Blinks,” *New York Times*, November 4, 2013, <http://dealbook.nytimes.com/2013/11/04/after-a-decade-sac-capital-blinks/>

22 Michiyo Nakamoto and David Wighton, “CitiGroup Chief Stays Bullish on Buyouts,” *Financial Times*, July 9, 2007, <http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz2mSZC3Swy>

23 Lynn Stout, June 2012.

24 Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” *Journal of Financial Economics*, Volume 3, No. 4, October 1976.

subsequent paper in 1989 written with Kevin Murphy, Jensen went even further, arguing that the reason corporate executives acted more like “bureaucrats than value-maximizing entrepreneurs” was because they didn’t get to keep enough of the extra value they created.²⁵

With that academic foundation, and the enthusiastic support of executive compensation specialists, stock-based compensation took off like a rocket.²⁶ Given the tens and, in more than a few cases, the hundreds of millions of dollars lavished on individual executives, the focus on boosting share price, is hardly surprising. The ultimate irony, of course, is that the result of this lavish campaign to better align incentives and interests is that the “agents” have done considerably better than the “principals.”

Roger Martin, the outgoing dean of the Rotman School of Management at the University of Toronto, calculates that from 1932 until 1976—roughly speaking, the era of “managerial capitalism” in which managers sought to balance the interest of shareholders with those of employees, customers and the society at large—the total real compound annual return on the stocks of the S&P 500 was 7.6 percent. From 1976 until 2011—roughly the period of “shareholder capitalism”—the comparable return has been 6.4 percent. Meanwhile, according to Martin’s calculation, the ratio of chief executive compensation to corporate profits increased eight fold between 1980 and 2000, almost all of it coming in the form of stock-based compensation.²⁷

HOW SHAREHOLDER PRIMACY HAS RESHAPED CORPORATE BEHAVIOR

All of this reinforcing infrastructure—the academic underpinning, the business school indoctrination, the threat of shareholder lawsuits, the Wall Street quarterly earnings machine, the executive compensation—has now succeeded in hard-wiring the shareholder value ideology into the economy and business culture. It has also set in motion a dynamic in which corporate and investor time horizons have become shorter and shorter. The average holding periods for corporate stocks, which for decades was six years, is now down to less than six months.²⁸ The average tenure of a Fortune 500 chief executive is now down to less than six years.²⁹ Given

25 Michael C. Jensen and Kevin J. Murphy, “CEO Incentives: Its Not How Much You Pay, But How,” *Harvard Business Review* (May/June, 1990), pp. 138-153.

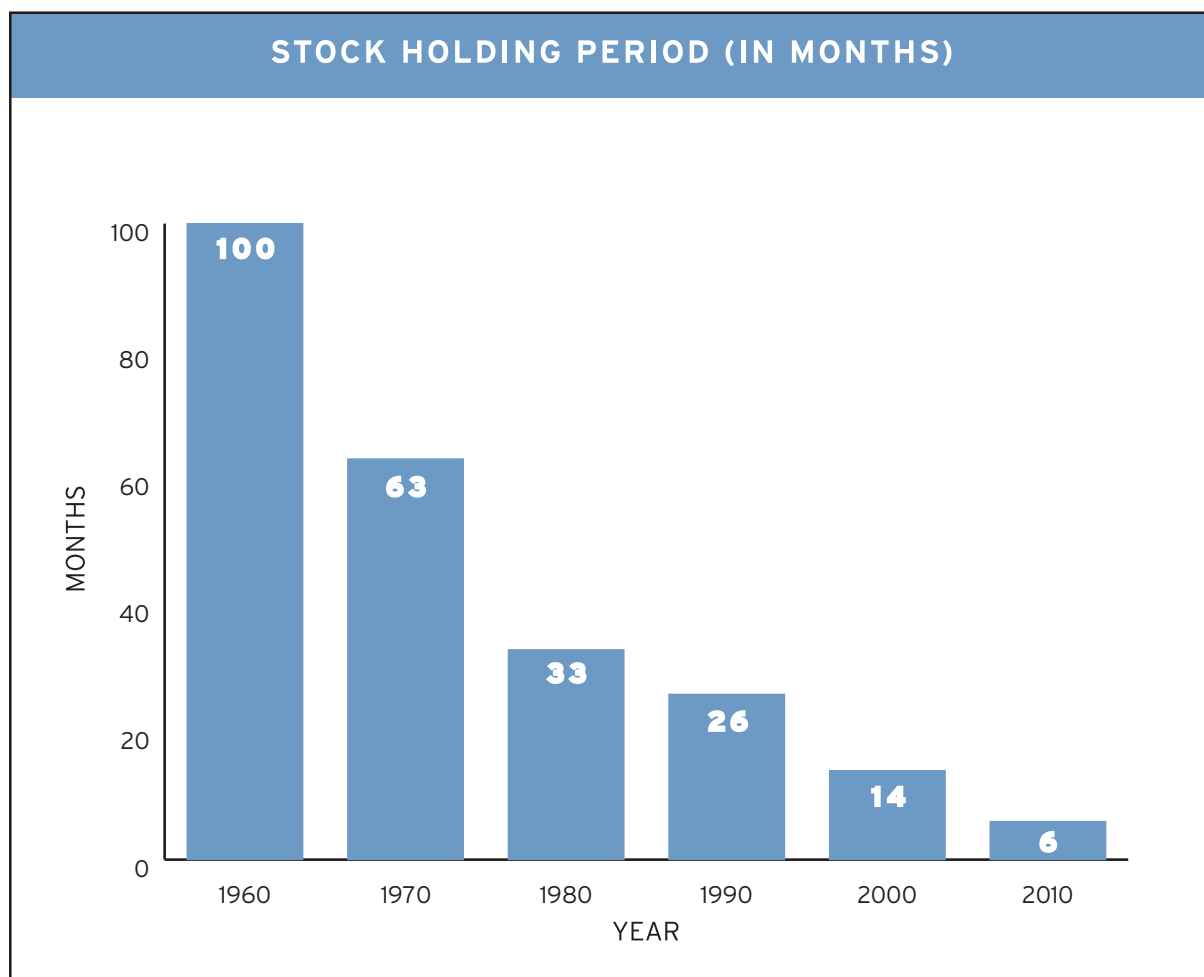
26 Currently, stock options, also known by the deceptively moniker performance-based restricted stock, is the fastest-growing form of executive compensation making up 27.4 percent of total CEO compensation in 2012 according to Scott Thurm, “Stock Options Sneak Back into the Pay Mix - By Another Name,” *Wall Street Journal*, May 15, 2013.

27 Roger L. Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL*, Harvard Business Review Press: Boston, MA, 2011.

28 Sam Ro, “Stock Market Investors Have Become Absurdly Impatient,” *Business Insider*, August 7, 2012, <http://www.businessinsider.com/stock-investor-holding-period-2012-8>.

29 Steven Kaplan and Bernadette Minton paper, “How Has CEO Turnover Changed,” 2008, <http://faculty.chicago-booth.edu/steven.kaplan/research/km.pdf>.

those realities, it should be no surprise that the willingness of corporate executives to sacrifice short-term profits to make long-term investments is rapidly disappearing.



Source: NYSE Fact Book (see www.nyxdata.com)

A recent study by McKinsey & Co., the blue chip consulting firm, and Canada's public pension board found alarming levels of short-termism in the corporate executive suite. According to the study, nearly 80 percent of top executives and directors reported feeling the most pressure to demonstrate a strong financial performance over a period of two years or less, with only 7 percent feeling a strong pressure to deliver strong performance over a period of five years or more. It also found that 55 percent of chief financial officers would forgo an attractive investment project today if it would cause the company to even marginally miss their quarterly earnings target.³⁰

³⁰ Press release entitled "CPP Investment Board and McKinsey & Company: Global Survey Signals Short-Term Pressures on Business Leaders Are Mounting," May 22, 2013, <http://online.wsj.com/article/PR-CO-20130522-911497.html>.

The shift on Wall Street from long-term investing to short-term trading presents a dilemma for those running a company run solely for shareholders: Which shareholders is it whose interests the corporation is supposed to optimize? Should it be the hedge funds that are buying and selling millions of shares in a matter of seconds to earn hedge fund-like returns? Or the “activist investors” who have just bought a third of the shares? Or should it be the retired school teacher in Dubuque who has held the stock for decades as part of her retirement savings and wants a decent return with minimal downside risk?

One way to deal with this quandary would be for corporations to give shareholders a bigger voice in corporate decision-making. But it turns out that even as they proclaim their dedication to shareholder value, executives and directors have been doing everything possible to minimize shareholder involvement and influence in corporate governance. This curious hypocrisy is most recently revealed in the all-out effort by the business lobby to limit shareholder “say on pay” or to have the right to nominate a competing slate of directors.³¹

For too many corporations, “maximizing shareholder value” has also provided justification for bamboozling customers, squeezing employees, avoiding taxes and leaving communities in the lurch. For any one profit-maximizing company, such ruthless behavior may be perfectly rational. But when competition forces all companies to behave in this fashion, neither they, nor we, wind up better off.

Take the simple example of outsourcing production to lower-cost countries overseas. Certainly it makes sense for any one company to aggressively pursue such a strategy. But if every company does it, these companies may eventually find that so many American consumers have suffered job loss and wage cuts that they no longer can buy the goods they are producing, even at the cheaper prices. The companies may also find that government no longer has sufficient revenue to educate its remaining American workers or dredge the ports through which its imported goods are delivered to market.

Economists have a name for such unintended spillover effects—negative externalities—and normally the most effective response is some form of government action, such as regulation, taxes or income transfers. But one of the hallmarks of the current political environment is that every tax, every regulation and every new safety net program is bitterly opposed by the corporate lobby as an assault on profits and job creation. Not only must the corporation

³¹ Nov. 18, 2010 letter to the Securities and Exchange Commission from the Chambers Center for Capital Market Competitiveness. See “CEOs openly oppose plan for say on pay by shareholders,” USA Today, July 17, 2009, http://usatoday30.usatoday.com/money/companies/management/2009-07-15-ceo-say-on-pay-shareholders_N.htm; In addition, the Business Roundtable and the Chamber of Commerce went to the US Court of Appeals for the District of Columbia and filed suit against the SEC to prevent a regulation from going into effect that would have given unhappy shareholders the ability to nominate competing slates of directors, an issue known as “proxy access,” another provision of the Dodd-Frank bill. The suit, Business Roundtable and Chamber of Commerce v. SEC, was decided in favor of the SEC, [http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/\\$file/10-1305-1320103.pdf](http://www.cadc.uscourts.gov/internet/opinions.nsf/89BE4D084BA5EBDA852578D5004FBBBE/$file/10-1305-1320103.pdf).

commit itself to putting shareholders first—as they see it, the society must as well. And with the Supreme Court’s decision in *Citizens’ United*,³² corporations are now free to spend unlimited sums of money on political campaigns to elect politicians sympathetic to this view. Perhaps the most ridiculous aspect of shareholder-uber-alles is how at odds it is with every modern theory about managing people. David Langstaff, chief executive of TASC, a Chantilly-based government contracting firm, put it this way in a recent speech at a conference hosted by the Aspen Institute and the business school at Northwestern University.

“If you are the sole proprietor of a business, do you think that you can motivate your employees for maximum performance by encouraging them simply to make more money for you?” Langstaff asked rhetorically. “That is effectively what an enterprise is saying when it states that its purpose is to maximize profit for its investors.”³³

Indeed, a number of economists have recently been trying to figure out the cause of the recent slowdown in the pace of innovation and the growth in worker productivity. There are lots of possible culprits, but surely one candidate is that American workers have come to understand that whatever financial benefit may come from their ingenuity or increased efficiency is almost certain to be captured by shareholders and top executives.

The new focus on shareholders also hasn’t been a big winner with the public. Polls by the Gallup Organization show that people’s trust and respect in big corporations has been on a long, slow decline in recent decades—at the moment, only Congress and health maintenance organizations are lower. And when was the last time you saw a corporate chief executive lionized on the cover of a newsweekly magazine? Odds are it was probably the late Steve Jobs of Apple, who wound up creating more wealth for more shareholders than anyone on the planet by putting shareholders near the bottom of his priority list.

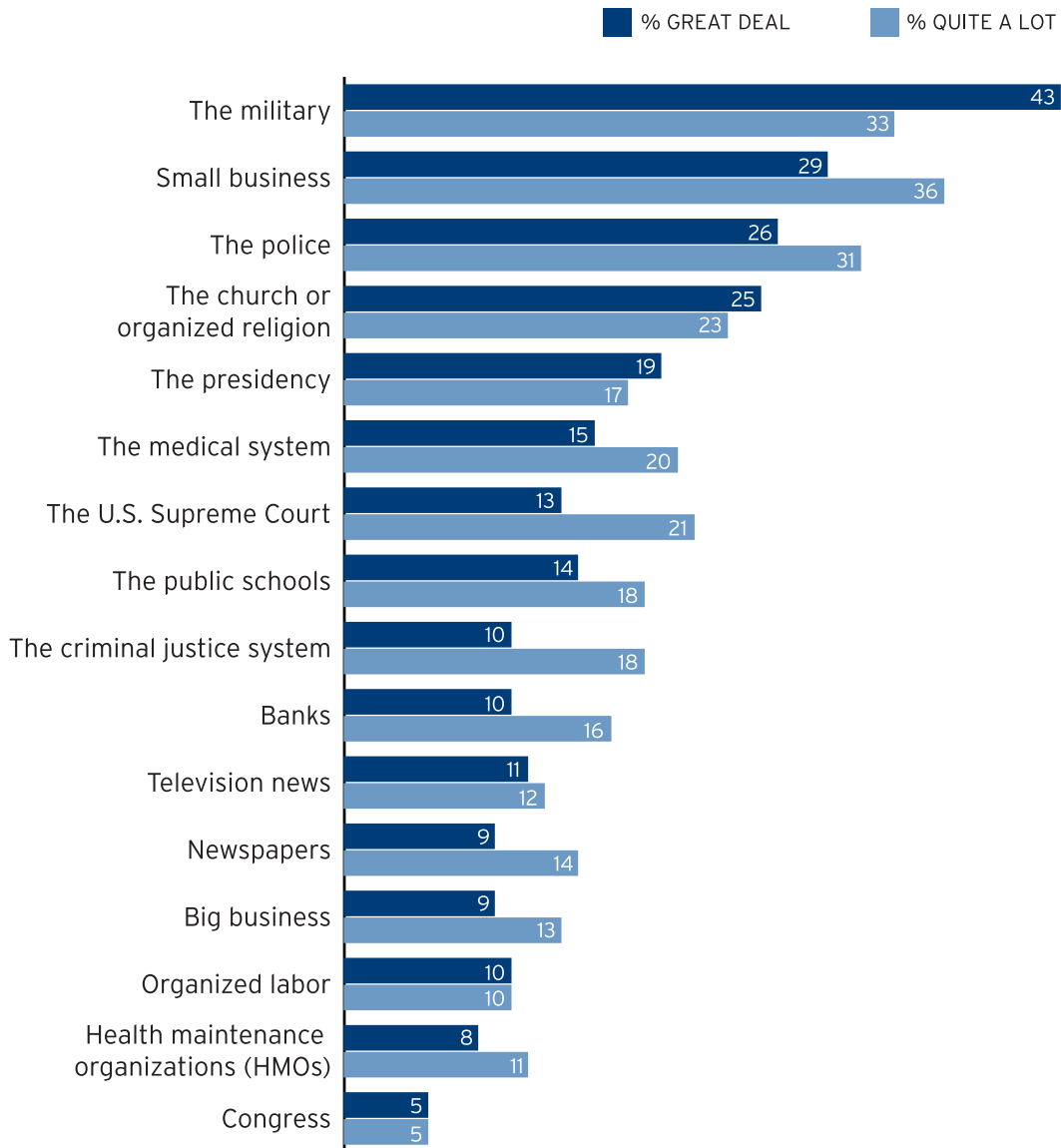
32 *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010).

33 David Langstaff, *Rethinking “Shareholder Value” and the Purpose of the Corporation*, speech delivered during the Aspen Institute Business and Society Program, March 7-8, 2013.

LEVEL OF CONFIDENCE IN AMERICAN INSTITUTIONS

I am going to read you a list of institutions in American society. Please tell me how much confidence you, yourself, have in each one: a great deal, quite a lot, some or very little?

June 1-4, 2013



Source: <http://www.gallup.com/poll/1597/confidence-institutions.aspx>

RISING DOUBTS ABOUT SHAREHOLDER PRIMACY

The usual defense you hear of “maximizing shareholder value” from corporate chief executives is that at many firms—not theirs!—it has been poorly understood and badly executed. These executives make clear they don’t confuse today’s stock price or this quarter’s earnings with shareholder value, which they understand to be profitability and stock appreciation over the long term. And they are quick to acknowledge that no enterprise can maximize long term value for its shareholders without attracting great employees, providing great products and services to customers and helping to support efficient governments and healthy communities.

Even Michael Jensen has felt the need to reformulate his thinking. In a 2001 paper, he wrote, “A firm cannot maximize value if it ignores the interest of its stakeholders.” He went on to offer a proposal he called “enlightened stakeholder theory,” one that “accepts maximization of the long run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders.”

But if optimizing shareholder value implicitly requires firms to take good care of customers, employees and communities, then by the same logic you could argue that optimizing customer satisfaction would require firms to take good care of employees, communities and shareholders. More broadly, optimizing any function inevitably requires the same tradeoffs or messy balancing of interests that executives of an earlier era claimed to have done.

The late, great management guru, Peter Drucker, long argued that if one stakeholder group should be first among equals, surely it should be the customer. “The purpose of business is to create and keep a customer,” he famously wrote.³⁴

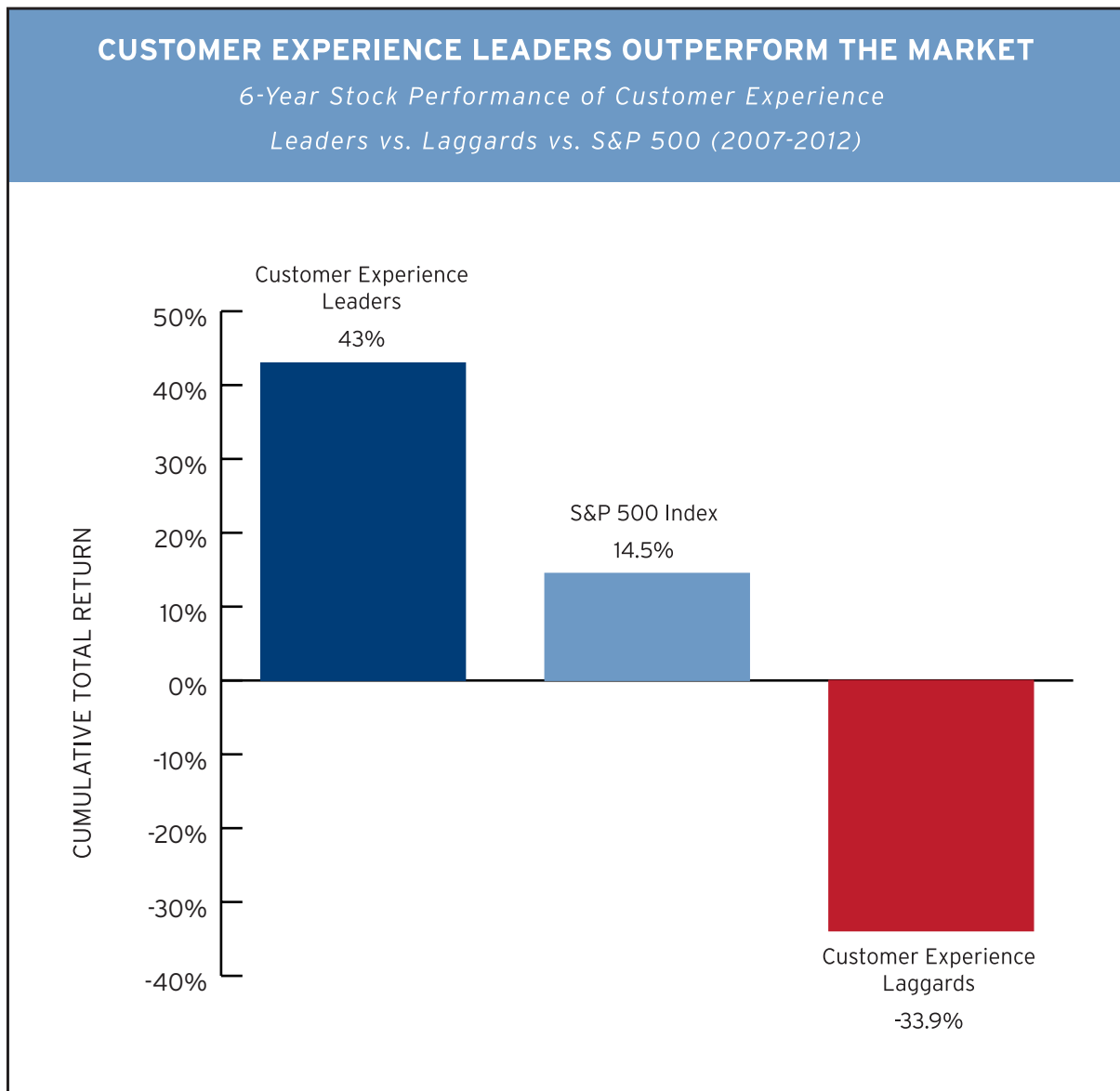
Roger Martin picked up on Drucker’s theme in “Fixing the Game,” his book-length critique of shareholder value. Martin cites the experience of companies such as Apple, Johnson & Johnson and Proctor & Gamble, companies that put customers first, and whose long-term shareholders have consistently done better than those companies that claim to put shareholders first. The reason, says Martin, is that customer focus minimizes undue risk taking, maximizes re-investment and creates, over the long run, a larger pie from which everyone can benefit.³⁵

A recent study by Jon Picoult of Watermark Consulting lends confirmation to Martin’s hypothesis. Picoult created two portfolios of stocks, one with the top ten companies in Forrester Research’s Customer Experience Index Rating, the other with the bottom ten

³⁴ Peter F. Drucker, *The Practice of Management*, 2nd edition, Harper Business: New York, October 2006.

³⁵ Roger L. Martin, 2011, *ibid.*

companies, and ran the numbers for the years 2007 to 2012. The customer service leaders had a five-year return of 43 percent, while the laggards lost 34 percent.³⁶



Source: Watermark defines Customer Experience Leaders and Laggards as the top ten and bottom ten rated public companies in Forrester Research's 2007-2103 Customer Experience Index studies. Comparison is based on performance of equally-weighted, annually readjusted stock portfolios of Customer Experience leaders and laggards relative to the S&P 500 Index. COPYRIGHT 2013 WATERMARK CONSULTING

Having spoken with more than a few top executives over the years, I can tell you that many would be thrilled if they could focus on customers rather than shareholders. In private, they chafe under the quarterly earnings regime forced on them by asset managers and the financial press. They fear and loathe "activist" investors. And they are disheartened by their low public esteem. Few, however, have dared to challenge the shareholder-first ideology in public.

³⁶ Watermark Consulting, "2013 Customer Experience ROI Study," 2013. <http://www.watermarkconsult.net/blog/2013/04/02/the-watermark-consulting-2013-customer-experience-roi-study/>

But recently, some cracks have appeared.

In 2006, Ian Davis, the managing director of McKinsey, gave a lecture at the University of Pennsylvania's Wharton School in which he declared, "Maximization of shareholder value is in danger of becoming irrelevant."

Davis' point was that global corporations have to operate not just in the United States, but in the rest of the world where people either don't understand the concept of putting shareholders first, or explicitly reject it—and companies that trumpet it will almost surely draw the attention of hostile regulators and politicians.

"Big businesses have to be forthright in saying what their role is in society, and they will never do it by saying, 'We maximize shareholder value.'"³⁷

A few years later, Jack Welch, the former chief executive of General Electric, made headlines when he told the Financial Times, "On the face of it, shareholder value is the dumbest idea in the world." What he meant, he scrambled to explain a few days later, is that shareholder value is an outcome, not a strategy.³⁸

"That's not a strategy that helps you know what to do when you come to work every day," Welch told Bloomberg BusinessWeek. "It doesn't energize or motivate anyone. So basically my point is, increasing the value of your company in both the short and long term is an outcome of the implementation of successful strategies."

Tom Rollins, the founder of The Teaching Company, offers as an alternative what he calls the "CEO strategy," standing for customers, employees and owners. Rollins starts by noting that at the foundation of all microeconomics are voluntary trades or exchanges that create "surplus" for both buyer and seller that in most cases exceed their minimum expectations. The same logic, he argues, ought to apply to the transactions between a company and its employees, its customers and its owners/shareholders.

The problem with a shareholder-first strategy, Rollins argues, is that it ignores this basic tenet of economics. It views any surplus earned by employees and customers as both unnecessary and costly. After all, if the market would allow the firm to hire employees for 10 percent less, or charge customers 10 percent more, then by not driving the hardest possible bargain with employees and customers, shareholder profit is not maximized.

37 "McKinsey's Ian Davis: Maximizing Shareholder Value Doesn't Cut It Anymore", accessed online at <http://knowledge.wharton.upenn.edu/article/mckinseys-ian-davis-maximizing-shareholder-value-doesnt-cut-it-anymore/>

38 Bloomberg BusinessWeek, "Jack Welch Elaborates: Shareholder Value, March 16, 2009, http://www.businessweek.com/bwdaily/dnflash/content/mar2009/db20090316_630496.htm

But behavioral research into the importance of “reciprocity” in social relationships strongly suggests that if employees and customers believe they are not getting any surplus from a transaction, they are unlikely to want to continue to do additional transactions with the firm. Other studies show that having highly satisfied customers and highly engaged employees leads directly to higher profits. As Rollins sees it, if firms provide above-market returns—surplus—to customers and employees, then customers and employees are likely to reciprocate and provide surplus value to firms and their owners.

At the Harvard Business School, professors Michael Porter and Mark Kramer have also rejected the false choice between a company’s social and value-maximizing responsibilities that is implicit in the shareholder value model.

“The solution lies in the principle of shared value, which involves creating economic value in a way that also creates value for society by addressing its needs and challenges,” they wrote in the *Harvard Business Review* in 2011. In the past, economists have theorized that for profit-maximizing companies to provide societal benefits, they had to sacrifice economic success by adding to their costs or foregoing revenue. What they overlooked, wrote Porter and Kramer, was that by ignoring social goals—safe workplaces, clean environments, effective school systems, adequate infrastructure—companies wound up adding to their overall costs while failing to exploit profitable business opportunities. “Businesses must reconnect company success with social progress,” wrote Porter and Kramer. Shared value is not social responsibility, philanthropy or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do, but at the center.”³⁹

SMALL STEPS TOWARD A MORE BALANCED CAPITALISM

If it were simply the law that could explain the undue focus on shareholder value, that would be relatively easy to undo. Changing a behavioral norm, however—particularly one so widely accepted and reinforced by so much supporting infrastructure—is a tougher challenge. The process will, of necessity, be gradual, requiring carrots as well as sticks. The goal should not be to impose a different but equally inflexible focus for corporate decision-making as maximizing shareholder value has been, but rather to make it acceptable for executives and directors to experiment with and adopt a variety of goals and purposes.

Companies would surely be responsive if investors and money managers would make clear that they have a longer time horizon or are looking for more than purely bottom line results.

³⁹ Michael E. Porter and Mark R. Kramer, “Creating Shared Value,” *Harvard Business Review Magazine*, January 2011.

There has long been a small and growing universe of “socially responsible” investing made up of mutual funds, public and union pension funds and research organizations that monitor corporate behavior and publish scorecards based on an assessment of how they treat customers, workers, the environment and their communities. While there are socially-responsible funds and asset managers and investors that have consistently achieved returns comparable or even slightly superior to those of competitors focused strictly on financial returns, there is no evidence of any systematic advantage. Nor has there been a large hedge fund or private equity fund that made it to the top of the league tables with a socially-responsible investment strategy. You can do well by doing good, but it’s no sure thing that you’ll do better.

Twenty states—the latest is Delaware, where a million businesses are legally registered—have recently established a new kind of corporate charter—the Benefit Corporation—that explicitly commits companies to be managed for the benefit of all stakeholders. About 300 companies, including Patagonia and Seventh Generation, now have B charters, while 800 have been certified as meeting the standards set out by the non-profit B Lab. Although almost all of today’s B corps are privately held, supporters of the concept hope there will be a sufficient number of sizeable firms that their stocks will be traded on a separate exchange.⁴⁰

One big challenge facing B corps and the socially-responsible investment community is that the criteria they use to assess corporate behavior exhibit an unmistakable liberal bias that makes it easy for a lot of investors, money managers and executives to dismiss them as ideological and naïve. Even a company run for the benefit of multiple stakeholders will at various points be forced to make tough choices, such as reducing payroll, trimming costs, closing facilities, closing plants, switching suppliers or doing business in places where corruption is rampant or environmental regulations are weak. And as chief executives are quick to remind, companies that ignore short-term profitability run the risk of never making it to the long term.

Among the growing chorus of critics of “shareholder value,” a consensus is emerging around a number of relatively modest changes in tax and corporate governance laws that, at a minimum, could help lengthen time horizons of corporate decision-making.

A group of 60 business leaders assembled by the Aspen Institute to address the problem of “short-termism” recommended a recalibration of the of the capital gains tax to provide investors with lower tax rates for longer-term investments.⁴¹ A small transaction tax, such as

40 For more information on Benefit Corporations (B-Corps) see Jena McGregor, “Creating a class of ‘do good’ companies,” <http://www.washingtonpost.com/blogs/on-leadership/wp/2013/09/20/creating-a-class-of-do-good-companies> and Marc Gunther, “B Corps: Sustainability will be shaped by the market, not corporate law,” <http://www.theguardian.com/sustainable-business/b-corps-markets-corporate-law>

41 Aspen Institute Business Leaders Dialogue, August 1-3, 2013, Aspen, Colorado.

the one as proposed by the European Union, could also be used to dampen the volume and importance of short-term trading.

The financial services industry and some academics have argued that such measures, by reducing market liquidity, will inevitably increase the cost of capital and result in markets that are more volatile, not less.⁴² A lower tax rate for long-term investing has also been shown to have a “lock-in effect” that discourages investors from moving capital to companies offering the prospect with the highest return.⁴³

But such conclusions are implicitly based on the questionable assumption that markets without such tax incentives are otherwise rational and operate with perfect efficiency. They also beg fundamental questions about the role played by financial markets in the broader economy. Once you assume, as they do, that the sole purpose of financial markets is to channel capital into investments that earn the highest financial return to private investors, then maximizing shareholder value becomes the only logical corporate strategy.

There is also a lively debate on the question of whether companies should offer earnings guidance to investors and analysts—estimates of what earnings per share will be for the coming quarter. The argument against such guidance is that it reinforces the undue focus of both executives and investors on short-term earnings results, discouraging long-term investment and incentivizing earnings manipulation.⁴⁴ The counter-argument is that even in the absence of company guidance, investors and executives inevitably play the same game by fixating on the “consensus” earnings estimates of Wall Street analysts. Given that reality, they argue, isn’t it better that those analyst estimates are informed as much as possible by information provided by the companies themselves?⁴⁵

In weighing up these conflicting arguments, the Aspen group concluded that investors and analysts would be better served if companies provided information on a wider range of metrics with which to assess and predict business performance over a longer time horizon than the next quarter.⁴⁶ While it might take Wall Street and its analysts some time to adjust to this richer and more nuanced form of communication, it would give the markets a better

42 Anna Pomeranets and Daniel Weaver. “Security transaction taxes and market quality.” Bank of Canada Working Paper 2011-26 (2012).

43 Steven Kaplan, “The Holding Period Distinction of the Capital Gains Tax,” NBER Working Paper No. 762, September 1981 and Thornton Matheson, “Taxing Financial Transactions: Issues and Evidence,” IMF Working Paper Fiscal Affairs Department, March 2011.

44 Warren Buffett is among those critical of providing quarterly earnings guidance. His views are outlined in this article: Andrew Countryman, “A Distaste for Earnings Guidance,” Chicago Tribune, December 22, 2002, http://articles.chicagotribune.com/2002-12-22/business/0212220276_1_earnings-guidance-earnings-per-share-warren-buffett

45 Baruch Lev, “The Case for Guidance,” Wall Street Journal, February 27, 2012, <http://online.wsj.com/news/articles/SB10001424052970203391104577124243623258110>.

46 Aspen Institute Business Leaders Dialogue, August 1-3, 2013, Aspen Institute, Aspen, Colorado.

understanding of what drives each business while taking some of the focus off the quarterly numbers game.

In addressing the question of which shareholders should have the most say over company strategies and objectives, there have been suggestions for giving long-term investors greater power in selecting directors, approving mergers and asset sales and setting executive compensation. The idea has been championed by McKinsey Managing Director Dominic Barton⁴⁷ and John Bogle, the former chief executive of Vanguard⁴⁸, and is under active consideration by European securities regulators.⁴⁹ Such enhanced voting rights, however, would have to be carefully structured so that they encourage a sense of stewardship on the part of long-term investors without giving company insiders or a few large shareholders the opportunity to run roughshod over other shareholders.

If I had to guess, my hunch would be that rather than well-meaning investors, it will be a new generation of employees who finally free the corporate sector from the straightjacket of shareholder value. Today, young people—particularly those with skills that are in high demand—are drawn to work not that simply pays well, but also has meaning and social value. You can already see that reflected in what students are choosing to study, how recruiting is done on university campuses and where highly-sought graduates are choosing to work. As the economy improves and the baby boom generation retires, companies that have reputations as ruthless maximizers of short-term profits will find themselves on the losing end of the global competition for talent.

In an era of plentiful capital, it will be skills, knowledge and creativity that will be in short supply, with those who have it calling the corporate tune. Who knows? In the future, there might even be conferences at which hedge fund managers and chief executives get together to gripe about the tyranny of “maximizing employee satisfaction” and vow to do something about it.

47 Dominic Barton, “Capitalism for the Long Term,” *Harvard Business Review*, March 2011.

48 Simon C. Y. Wong, “Rethinking ‘One Share, One Vote,’” *Harvard Business Review Blog Network*, January 29, 2013, <http://blogs.hbr.org/2013/01/rethinking-one-share-one-vote/>

49 *Ibid.*

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