MAKING CAPITALISM MORE INCLUSIVE

Selected Speeches and Essays from Participants at the Conference on Inclusive Capitalism

London, 27 May 2014

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Section 3: Shareholder value and societal good

The two authors in this section explore related questions that lie at the heart of our economic system and our efforts to make capitalism more inclusive: should the goal of companies be to maximise shareholder value, and are the goals of shareholder value maximisation and societal good always in opposition?

Martin Wolf argues that shareholder value maximisation is not an appropriate goal. His thesis is that companies exist to create economic value but that shareholders do not have exclusive rights to that value.

He argues against shareholder control on the grounds that shareholders do not, in fact, bear the greatest risk in corporations. They can hedge across their ownership portfolio and are therefore far more fickle in their behaviour than those who must invest in company-specific skills – long-term employees and dedicated suppliers. For this reason, shareholder control fails to optimise company performance.

And even if shareholders wish to maximise value they are not best placed to do this. They do not have adequate information and they cannot rely on their delegated employees – management – as management incentives are misaligned. Stock options that tie management remuneration to stock price performance are not effective both because management controls public perceptions of the company – and thus affects share price, regardless of underlying value – and because management typically bears limited downside risk.

Roger Martin argues that there is not an inherent trade-off between shareholder value maximisation and societal good. Economists frequently see trade-offs as inevitable and therefore create theories that assume this to be the case. We end up with self-fulfilling prophecies. If we backtrack and recognise that there is no inherent trade-off, managers are far more likely to be creative in identifying paths that maximise both shareholder value and societal good. Indeed, they can be taught to think in this way.

If both authors are right, we end up with an argument that shareholder value maximisation is neither a legitimate goal, nor is it something that managers need to trade off with societal needs.

That being the case, the questions become somewhat different. Rather than thinking about the pros and cons of shareholder value maximisation, we should concern ourselves, instead, with identifying what we need to know to recognise and maximise societal good within companies?

Secondly, we need to think far more seriously about the forms of control that will help management do this. This brings us to questions of ownership structures that link back to other papers in the volume, especially that written by Sir Charlie Mayfield in the previous section.

Should companies maximise shareholder value?

Martin Wolf
Associate Editor and Chief Economics Commentator, *Financial Times*

What is a company? What is its purpose? Who owns it? What should be its goal?

These are four closely related questions. The answers society gives will determine the future of capitalism. Those answers are also hard to find, because the limited liability company, though an extraordinarily successful institution, is a hybrid institution: it is in the market economy, but not of it.

So what is a company? As the late Ronald Coase, a Nobel laureate in economics, taught, if one wants to organise production and sales of complex products and services, a (semi)-permanent institution will outperform an array of small businesses forced to deal with one another through market contracts. Companies exist because hierarchies - 'command and control' - beat markets. The genius of the company is to import the hierarchical structure of older institutional forms - bureaucracies and armies - into the market economy.

The advantage companies possess is the mirror image of the costs of creating and monitoring a vast number of detailed contracts under uncertainty about future requirements. Organising economic processes successfully often requires the scale of an army and the longevity of a tortoise.

A life insurer is of little use if it will not meet its obligations 80 years hence. A maker of jet engines is of little use if it will be unable to service and replace its engines over their lifetime. A car manufacturer is of little use if it is unable to use what it has learned from today's models to build tomorrow's.

A company is built upon a set of relational, or implicit, contracts. These say something like the following: 'we will purchase your services for a more or less indefinite period; we will look after you; and, in return, you will do what we tell you'.

The corporate form was a brilliant innovation. But, like many innovations, it has created new challenges.

In order to work, such entities need vast amounts of capital. In the beginning, these funds are mainly provided by shareholders. Thereafter, they mostly come from retained earnings and further borrowing.

In return for providing risk capital, shareholders are entitled to the stream of corporate profits, whether paid out as dividends or share buy-backs, or retained within the company. If things go well, shareholders have a profitable investment. Under limited liability, if things go badly, they will lose their investment, but no more than their investment.

What is the goal of a company? It is an institutional mechanism for adding economic value. This is the social function of any and all companies, subject to an important proviso: the company should not add value by inflicting negative externalities, such as environmental degradation. Society has given the corporate form important privileges. In return, society has a right to expect obedience to the law and a measure of decency: even if it is not illegal, dumping toxic waste or rigging one's affairs so as to pay minimal taxes to the jurisdictions that provide the environment within which the company can generate its profits is indecent. It is freeloading.

A company adds value by organising its array of assets - skills, knowledge, values, traditions and loyalties - into an effective and flexible whole. It is succeeding if it prospers in a competitive market. It fails if it does not.

It is almost always possible for a company to make higher short-term profits by sacrificing investments that allow it to prosper in the long run. But companies were created in order to endure. Ownership can change hands, be fragmented, or re-unified, without significant impact on the company itself. Caring about its future is part of a company's *raison d'être*.

Who owns and controls a company? The formal answer of economists has been that shareholders own and control a company. This is simplistic.

Shareholders do not own companies in the normal sense of ownership. They cannot walk into the property they 'own' and demand that 'their' employees do certain things, as they could in a shop or a farm that they owned. Indeed, all they can do - and, for the most part, only with difficulty - is to help change management by voting or selling their shares. This is a highly qualified form of ownership.

A closely related question is whether shareholders should control companies. In the English-speaking countries, the answer is immediate and unambiguous: yes. Almost anywhere else, it is, to a greater or lesser extent, no. The difference is more intellectual and cultural than legal.

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In Germany or Japan, for example, shareholders have a right to consideration, but not to control. Control rests, instead, with management, whose responsibilities are to the company as an enduring entity. In such countries, the answer to the question of who owns a limited liability company is that nobody really does, any more than someone can own, say, a university.

Is it clear who is right? No, because, as noted above, the limited liability company is a hybrid entity.

The arguments in favour of shareholders' control rights are two: first, shareholders are the residual claimants and so bear the residual risks; second, somebody has to have the capacity to evict management. If it is not the shareholders, who should it be? The advantage of an Anglo-Saxon shareholder-governed company is that fundamental shifts in management and direction are relatively simple to make.

The argument against this view is that in a shareholder-controlled company some valuable implicit contracts - for example, willingness to undertake unpleasant and inconspicuous tasks in the hope of reward in subsequent employment, or willingness to invest heavily in one's ability to work within a specific team - will not be made.

The explanation for this difficulty is that contrary to the normal view, shareholders do not bear the largest proportion of the uninsurable risk in a company. Shareholders can diversify their portfolios and usually do, thus insuring themselves against company-specific risk. The people who cannot do this are those who make large investments in company-specific skills, knowledge and relationships, protected, they hope, by the implicit contracts that justify the corporate form. This category may include both long-serving workers and dedicated suppliers.

Without a measure of control, such implicit contracts are unlikely to prove worth the paper they are not written on. If those who are called upon to invest in implicit contracts know they have limited, if any, influence on those who control the company, they must then also know that opportunistic default is possible and, in the right circumstances, certain. They will rationally not make those investments. In such cases, shareholder control actually undermines corporate success.

Finally, what should the operational goal of a company be? Should it be to maximise shareholder value, defined, as it should be, as 'maximising the present value of free cash flows from now until infinity, discounted at a rate that reflects the risks of these cash flows'?

The answer is yes if and only if two conditions hold. The first is that the prices of the goods and services (including labour services) that a company buys and sells reflect their true social costs and benefits. The second is that the goal can be made operational in a beneficial rather than a perverse way. Neither is plausible.

The biggest difficulty with the first of these conditions lies in the labour market. The social costs of lay-offs are not internalised by the company. But that can be dealt with by imposing a regulation or tax.

A far greater difficulty is the second. Shareholders do not know what policies will maximise the present value of a company's free cash flow to infinity. In fact, they have virtually no idea.

Most of them also have no incentive to invest in the relevant knowledge either. Unless they own a large share of the company, they will suffer from the collective action problem described by the late Mancur Olsen: the costs of investment in knowledge is borne by each of them, but the benefits are shared amongst all. As a public good, knowledge is always undersupplied in the market.

This is, note, not the same as saying stock markets are inefficient in their ability to evaluate the prospects of one company vis-à-vis another (though they are certainly inefficient at the aggregate level). That is because shareholder ignorance is likely to shape what the company does. It is a self-fulfilling prophecy.

Shareholders seek to align the interests of corporate management with their own by relating remuneration to the price of shares. But this fails. A relatively straightforward reason for this is that management does not share in the downside of other shareholders. Stock options, for example, are a one-way bet even if they are not manipulated, as they (and other managerial rewards) can so easily be.

A far more important reason is that management can game the outcome. It controls views about the future of the company and manages the company's cash flows. It can massage earnings and expectations.

This then leads to competition among companies to ensure that their chief executive's pay is not below the median: who wants to admit that their appointee is second rate? It is almost a matter of status. It is certainly a matter of status for chief executives who usually have at least some influence on who sits on remuneration committees. This then swiftly becomes a red queen's race. Even Jack Welch, former boss of GE, has called the maximisation of shareholder value 'the dumbest idea in the world'. He should surely know.

It is no accident that the remuneration of executives has exploded since the acceptance of shareholder value maximisation, particularly in the English-speaking countries. It is true that corporations have also become profitable. But underlying productivity growth has weakened, certainly in comparison with performance before the 1970s. Shareholders have prospered. But companies have not been delivering social value.

How then should the company be run to fulfil its purpose - the delivery of economic value to society? The assumptions under which the maximisation of shareholder value is the best way to achieve that broader goal do not hold. Both the goal and way it has been made operational have to be questioned. At present it is generating a capitalism that benefits the few rather more than the many. This cannot - and must not - endure.

> Contrary to the normal view, shareholders do not bear the largest proportion of the uninsurable risk in a company.

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Martin Wolf is Associate Editor and Chief Economics Commentator at the *Financial Times*. He was awarded the Commander of the British Empire (CBE) in 2000 for services to financial journalism. Mr Wolf was joint winner of the Wincott Foundation senior prize for excellence in financial journalism for 1989 and 1997. He won the 2009 Ludwig Erhard Prize for economic commentary. He won the 33rd Ischia International Journalism Prize in 2012. He was a Member of the UK's Independent Commission on Banking in 2010-11. His most recent publications are *Why Globalization Works* and *Fixing Global Finance*.

Self-fulfilling prophesies and inclusive capitalism

Roger Martin
Academic Director, *Martin Prosperity Institute, Rotman School of Management, University of Toronto*

The prevailing view of modern capitalism holds that corporations naturally behave, like water flowing downhill, in ways that produce insufficiently inclusive outcomes. Proponents of inclusive capitalism want corporations to behave differently. This is, they argue, a tough task because it necessitates the moral equivalent of making water flow uphill.

By contrast, I would argue that this dominant frame - accepted alike by proponents and opponents - is an artificial construct that, rather than illuminating the challenge, actually represents a barrier to the flourishing of inclusive capitalism. It needs to be exposed for what it is and replaced by a better theory.

Two pieces of research and writing help provide a more useful frame: the first is the work of the late Sumantra Ghoshal on self-fulfilling prophecies in management theory; and the second is my own work on integrative thinking. Together these bodies of work suggest that it is within our control to generate a self-fulfilling frame in which inclusive capitalism switches from being like water flowing uphill to water flowing downhill.

Self-fulfilling prophecies

In 2005, a year after Sumantra Ghoshal's sudden death of a brain hemorrhage, the Academy of Management Learning & Education published his manuscript *Bad Management Theories are Destroying Good Management Practices*. Ghoshal argued that - unlike in the hard sciences - in the social sciences, theories actually influence the behaviour of actors in ways that can cause the theory to become a self-fulfilling prophecy. This can be true even if the theory actually had no particular validity in the first place.

For example, if the prevailing theory in an industry is that consumers won't pay extra for quality, producers will not invest in enhancing quality. Any observer who studies that industry will come to the conclusion that consumers definitively don't pay for quality (better quality is not, in this case, available). This, in turn, reinforces the belief that the theory was right in the first place, whether in fact it was or was not.

In management studies, in particular, Ghoshal argued that the academic field has been taken over by theories that embody a 'gloomy vision' of human behaviour, a description he borrowed from Albert Hirschman. More specifically still, these are theories rooted in the discipline of economics, which preaches that the core managerial function is one of making trade-offs between desirable but incommensurable goals. Economics students regularly start by learning about the trade-off an economy needs to make between guns and butter.

As those who graduate from the management schools that teach this theory flow out into the business world, they see their jobs as making - and justifying the making of - unpleasant trade-offs.

Central among these trade-offs is the one between shareholder value maximization and benefiting society.

> The core task of management is not to choose between shareholder value maximization and benefit to society; it is to seek creative resolutions that enhance both.

According to Ghoshal, the very fact that they believe in the validity of this theory ensures that they spend their careers making, and justifying the making of, unpleasant trade-offs. As a result, anyone observing the trade-off activities will conclude that this is what business life is all about: making unpleasant trade-offs.

That makes the task of promoting inclusive capitalism one of convincing managers to make an unpleasant trade-off, promoting inclusive capitalism *at the expense of* shareholder value maximization - a tough task.

It is time to recognise that this is an artificial construct, the product of bad theory and the self-fulfilling prophecy that arises out of it, rather than being a reflection of a real-world dilemma.

Integrative thinking

My study of how highly successful leaders think, published in 2007 in *The Opposable Mind*, argued that when facing what appears to be an unpleasant trade-off between incommensurable options, there is always, in fact, another alternative to choosing one at the expense of the other. Successful leaders seek out a creative resolution of the tension between the opposing models by generating a solution that contains elements of each, but is superior to both.

The main thing that stops executives from seeking a creative resolution is their belief that life is inherently full of difficult such trade-offs and that the only course of action is, therefore, to make a difficult choice. This is, of course, what Ghoshal would have predicted. The prevailing economics-based theory of trade-offs creates a self-fulfilling prophecy so that making the trade-off is the dominant response. This simply reinforces the perception that making the either/or choice is the optimal behaviour in response to an apparent trade-off.

My research on successful leaders demonstrates that the trade-off isn't inherent and binding. It is constructed, yet it too easily becomes a self-fulfilling prophecy.

The framing of this issue represents a case of bad management that lacks initial validity but gains credibility through reinforcement because managers act on it, believing it to be true.

Implications for inclusive capitalism

It is unhelpful to promote the existence of a trade-off between shareholder value maximization and benefit to society, and then plead with managers to trade the former off for the latter. This simply entrenches the self-fulfilling prophecy and makes it harder to dispel. Instead, proponents of inclusive capitalism should argue that the trade-off is not inherent; it is a product of the model in people's heads. The core task of management is not to choose between shareholder value maximization and benefit to society; it is to seek creative resolutions that enhance both.

Long-established companies such as Unilever or Lego have shown that this can be done. Newer companies, like Google, are also demonstrating that a business can grow to large scale without having to revert to making these trade-offs. And start-ups such as Toms Shoes and Warby Parker can actually attribute their success centrally to doing both.

Of course, opponents of inclusive capitalism will point out that it is impossible to wish away all trade-offs and that at the margin - being economists, that is where they will go - there are always trade-offs. Indeed they are correct: there are and always will be trade-offs. But there is a difference between assuming that every situation necessarily involves an unpleasant trade-off between shareholder value maximization and societal benefit, and accepting that after much work to come up with a creative resolution of that tension and the failure to find such a resolution, a trade-off needs to be made.

The former world is one in which the 'gloomy vision' begets a gloomy result and the belief that gloominess is the natural order of things. The latter world is one in which hope and imagination are continually improving the world and there is a belief that improvement is the natural order of things. By heeding Ghoshal's warning and engaging in integrative thinking, inclusive capitalism can and will triumph.

The good news on this front is that integrative thinking can be taught - to executives, to graduate students, to undergraduate students and even K-12 students. I started with executives and with the help of my colleagues have moved down the age scale to elementary school students. Our experience is that anyone willing to try to learn integrative thinking most certainly can and does.

It will take some time for the students flowing out of the formal educational system to transform the business world. We are fortunate, though, that in this world, success can breed success. As the achievements of integrative thinkers become more obvious, there will be the kind of productive copy-catting that always goes on in business. In this way we can make the water start to flow productively downhill: inclusive capitalism will be the result.

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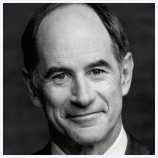
About the author



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Roger Martin was Dean of the Rotman School from 1998 to 2013. Prior to that he spent 13 years as a Director of Monitor Company, a global strategy consulting firm based in Cambridge, Massachusetts, where he served as co-head for two years. He serves on the boards of Skoll Foundation, Canadian Credit Management Foundation, Tennis Canada (past chair) and Ontario Task Force on Competitiveness, Productivity and Economic Progress (chair) and is a trusted advisor to a number of global companies. He has published eight books and extensive articles and blog posts, including for the Harvard Business Review.