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CAPITALISM FOR EVERYONE

MICHAEL FALK, CFA, AND
JOACHIM KLEMENT, CFA

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CAPITALISM FOR EVERYONE

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SHAREHOLDERS *AND* STAKEHOLDERS

> There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.
>
> *— Nobel Laureate Milton Friedman (1962)*

Is there any doubt about what proper corporate responsibility is? *Should* there be any doubt? The featured quote from Milton Friedman has been debated—and, for that matter, derided—more and more during the past decade. Should we not first seek to understand precisely what he meant?

First, we should understand that Mr. Friedman was not anti-stakeholder *per se*; he was concerned principally about corporate leaders spending other people's money without consent. Second, given what was happening in the world from the 1950s to the 1970s, we might extend Mr. Friedman a little grace. This era was the height of unionisation in the United States, and many people regarded business as a fat hog to be slaughtered—it was where the money was. Our context today is quite different.

Our greater scientific knowledge regarding climate offers one example of the differences. This understanding has put a spotlight on factories spewing carbon dioxide (CO_2), which we now know to be a negative externality. Should the "rules of the game" have to change to reflect today's knowledge that CO_2 is not harmless but a major, perhaps even the dominant, contributor to harmful climate change? Businesses must be responsible for covering their production costs, including known externalities. As our knowledge changes, externalities must be repriced accordingly.

CO_2 imposes a long-term cost on society as it builds up in the atmosphere and contributes to climate change. If CO_2 emissions are not priced, however, the "spewers" incur the benefits but no costs, while society suffers the damage and becomes responsible for the costs. This dynamic could not happen in a fair game. What makes the game fair is putting a price on all known externalities, a task that almost by definition falls to government. With that and other social norms achieved, business can maximise its profits. Perhaps Mr. Friedman's shareholders and everyone else's stakeholders might be able to share a meal after all. The clients, the employees, the owners, and society would all be invited. Oddly enough, this inclusive guest list forms the acronym CEOS.

We have now arrived at shareholders and stakeholders cooperating, rather than fighting each other. Of course, externalities are just one topic, albeit a large one, within this dialogue. Also topical are employees, suppliers' employees, customers, and the local and larger communities in which a business operates. How businesses earn their bottom lines—net income—matters. Let us briefly review how a fair game might be viewed, transparently, as seen from the bottom line:

- Clients/customers: A business might produce a product that is desired by its customers but has long-term negative consequences for them and/or for others. For example, who should pay for the long-term health costs of tobacco consumption, if not the businesses producing tobacco products?
- Employees: The simplest way for a business to increase net income would be to pay employees less or let some go, thereby reducing costs. The assumption that an unhappy employee could simply choose to work somewhere else for better pay is good in theory but not always possible or economical in practice. Open and free competition is not "always and everywhere." And lest we forget, employees' incomes are what (in aggregate) pay for the goods and services proffered by businesses. As an example, in January 1914, Henry Ford started paying his autoworkers a remarkable $5 a day. Doubling the average wage helped ensure a stable, more loyal, and more productive workforce. And it might have even marginally boosted sales because the workers could now afford to buy the cars they were making.
- Suppliers' employees: Another way for a business to increase its profits would be to pressure suppliers into discounting their goods. The simplest way for a supplier to make this happen is, again, through its employees.
- The environment: For the moment, we will move away from the climate debate. Businesses might use water or air resources in their production of goods without paying for them and could pollute those public resources. Free production inputs, with the cost of despoilment socialised, are not fair or economically optimal. And although we acknowledge that pricing such inputs is a challenge, we know their price should not be zero. More and better work must be done on pricing strategies.
- The local community: A business might require local amenities to operate traffic lights, perform road improvements, and provide other public services and could thereby add to congestion. To what extent is the business covering these costs, or at least those in excess of the local tax revenues it produces? Another important question to consider is whether local jobs are created, for the purpose of assessing how those jobs translate into local tax revenues.

Considering all of these stakeholders raises the question of whether the rules of the game provide for "sustainable" open and free competition. If economics is about the efficient allocation of resources, then *all* costs—whether visible or obscured—must be factored in. When they are not, allocations will be distorted. Shareholders are not the same people as the other stakeholders, but do they acknowledge that they are in fact in a relationship with the businesses in which they own shares? We use the word "acknowledge" because nothing is secret here;

this is not an illicit affair. But do businesses wish to take responsibility for all their costs, including externalities? Do they know what those costs are? Can they afford them through their current revenues or potential price increases? Would potential price increases be accepted? Those four questions can be answered only by including the stakeholders, not just the shareholders, in the information flow and decision-making process.

We have not yet defined "sustainable competition." Regardless, a business's costs of production should be its financial responsibility, or we will foster a "them" (entitled) versus "us" (stakeholder) mentality. This split has played a role in today's high level of inequality, which in turn has brought forth arguments against capitalism. Evolving the governance focus from being solely on the shareholders to including all stakeholders is a linchpin in sustainable competition.

FROM SHAREHOLDER VALUE TO STAKEHOLDER VALUE

Shareholder value maximisation as the dominant form of corporate governance was originally developed in the 1930s in the United States. This principle proved controversial almost from the beginning, as manifested in public discussions between legal scholars Adolf Berle and Merrick Dodd (Berle 1931; Dodd 1932; Berle 1932). Berle argued that because of the separation of ownership and management in a corporation, the managers' primary obligation is to run the company for the benefit of the ultimate owners. Dodd countered that corporations have responsibilities beyond those of the owners and toward other stakeholders in society. Thus, corporations should take into account the impact of their actions on other stakeholders when determining their course of action.

Ironically, from a legal perspective, shareholder value maximisation has its priorities in reverse. From a legal perspective, shareholders come last in a bankruptcy setting and are satisfied after debtors, tax authorities, and (depending on the jurisdiction) pension claims and wages to employees have been satisfied. But this legal setup is exactly what justifies the shareholder value maximisation approach. After all, if shareholder value is maximised, then all the other claims must be satisfied first.

From an economic perspective, shareholder value maximisation makes sense and can be viewed as a form of, or path to, stakeholder value maximisation. This concept holds true, however, only in a complete market with perfect competition (Magill and Quinzii 2009). In practice, few markets are frictionless and operate under perfect competition or are even approximately so. For example, in markets where shareholders are simultaneously employees of a company and consumers of the goods and services it manufactures, such individuals might be of two minds about how shareholder value should be maximised. For example, an employee of Ford who is also a shareholder might object to cost cutting at the company from his perspective as an employee (because it could cost him his job) but might agree with the cost-cutting measures from his perspective as a shareholder who benefits from higher profit margins. Farrell (1985) gives an even more interesting example, comparing a shareholder of Ford who already owns a Ford vehicle with a shareholder of the company who does not. The shareholder who already owns a Ford could be very much in favour of a high-profit-margin strategy of selling more expensive models, while the shareholder who does not own a Ford but maybe wants to purchase one in the future might be against such a premiumisation strategy.

Another practical aspect of the shareholder value maximisation approach is that most shareholders own not only one stock but a portfolio of stocks. Shareholders thus want to maximise the value of their portfolio, not of each individual stock. As Azar (2016) shows both theoretically and empirically, the result is increased pressure on management and directors to reduce cutthroat competition and instead eliminate inefficiencies from a lack of coordination. This need for coordination between firms, however, opens up the possibility that corporate executives cooperate with each other for their personal benefit rather than competing for the benefit of shareholders. In essence, corporate agents such as executives and directors might create a separate interest group that influences the firm's actions and has incentives that are not necessarily aligned with those of shareholders (e.g., with respect to executive compensation).

Two strands of literature have therefore developed. One tries to reduce or eliminate the principal–agent problems and align the incentives of managers with the goals of shareholders (see Zogning 2017 for a recent literature review). The other criticises shareholder value maximisation, calling it an erroneous target, and instead emphasises approaches that try to explicitly balance the interests of different stakeholders (e.g., Laplume, Sonpar, and Litz 2008). The literature on stakeholder value maximisation generally finds that managers have sufficient discretion to maximise across the combined goals of different stakeholders at once (McVea and Freeman 2005) and that stakeholder value optimisation can be superior to shareholder value maximisation. This argument between shareholder value optimisation and stakeholder value maximisation is ongoing, but the fronts have softened, and in practice, compromise solutions that try to balance both approaches have become more prevalent.

After all, the shortcomings of pure shareholder value maximisation have been exposed several times in the 20th and 21st centuries, most recently during the financial crisis of 2008, when mortgage lenders were providing loans to households that were eventually unable to service them. Lending to low-income households (or in extreme cases, so-called NINJA loans to households with no income, no job, and no assets) was not only legal but also perfectly in line with maximising shareholder value for the mortgage lender because the lender typically sold the mortgage to other parties rather than taking on the risk of getting the money back. Of course, in the long run, these lending practices destabilised the entire housing market and eventually the global economy. The example of NINJA loans shows how, at the extremes, shareholders and stakeholders are no longer distinct and separate. What is bad for one is bad for the other.

Meanwhile, extreme stakeholder value maximisation approaches have failed as well. In Japan, corporations were managed not only to maximise shareholder value but also with respect to the corporation's public image and in accordance with the needs of lenders and competitors. The famous *keiretsu* system of corporate crossholdings (often centred on a major lending institution) ensured that lenders and competitors had significant influence on a corporation's management. This system of crossholdings contributed heavily to the creation of zombie firms after the Japanese bubble of the 1980s burst because it prevented insolvent companies from defaulting on their debt and filing for bankruptcy. The result was an increasingly sclerotic corporate system that was unable to reform itself. The problem with ruling by committee is that when everybody is in charge, nobody is in charge. Japan's businesses have for too long been ruled by committees.

Enlightened Shareholder Value Maximisation

In 2002, Michael Jensen introduced a compromise approach to corporate management that has gained popularity and was in fact encoded as the legal standard for corporate management in the United Kingdom in the Companies Act 2006. Jensen (2002) calls his approach "enlightened shareholder value maximisation" and bases this approach on two core assumptions:

1. A corporation must have just one goal to behave purposefully. Jensen argues that one cannot optimise multiple goals at the same time because these goals might conflict with one another and thus make choosing impossible for management. In the worst case, Jensen argues, trying to maximise multiple goals at the same time allows management to avoid accountability and exploit different stakeholders to its own advantage.

   In our view, this assumption is flawed. One of us (Klement) is a trained mathematician, and stating that a corporation can maximise only one goal betrays a lack of mathematical knowledge. Different goals and their trade-offs can be combined into a single overarching goal in many ways. For example, we know from our own experience that families typically are not run as paternal dictatorships—nor are they the pure chaos sometimes depicted in TV dramas. Instead, family members talk with each other about their individual goals and needs. These discussions typically lead to compromise solutions intended to make everyone in the family happier. To arrive at these compromises, a family can use a formal structure, such as a family meeting to decide where to go on vacation next summer, or it can use informal dinner table conversations. The process might differ, but the end result is the same: a family that maximises the overall happiness of all its members. Arriving at this point, though, requires the three Cs: clarity, communication, and compromise. Ironically, in his second assumption, Jensen's enlightened shareholder value maximisation provides a method by which a corporation can do this.

2. Society benefits most if total firm value is maximised. Jensen argues that maximising total firm value also maximises societal benefits. After all, a firm's value is maximised if the corporation produces goods and services valued by customers. Creating highly valued products and services thus enhances overall welfare and firm value. Jensen is quick to acknowledge, however, that this claim holds true only in the absence of externalities and frictions. If companies do not have to bear the full cost of their actions, such as being able to pollute the environment without consequences or exploit slave labor in sweatshops, they can generate excess profits at the expense of society. Similarly, if companies have monopoly power or monopsony power, or if they form illegal trusts to stifle competition, they can extract profits from society and make society worse off while maximising their own value.

   In practice, these externalities and frictions are not the exception, as economists have historically assumed, but the norm. Take the tobacco industry, for example. Tobacco companies sold products that were highly valued by customers but that also killed them. The costs of treating cancer and other illnesses caused by smoking were borne by health insurers and taxpayers (who had to pay for government-sponsored health insurance, such as Medicare and Medicaid in the

> United States). For decades, the tobacco industry managed to maximise firm value at the expense of society and other businesses. Similarly, companies that pollute the environment can often get away with doing so for a long time before the detrimental effects of their actions become visible or costly. In the United States, President Richard Nixon introduced the Environmental Protection Agency in 1970 in reaction to decades of pollution of rivers and the air by corporations. The pollution had became so bad that some rivers in the United States caught on fire.
>
> The fight against monopolies, monopsony, and externalities is clearly not over. At the time of writing, the US Congress is investigating large tech companies such as Google, Facebook, and Amazon to determine whether they have effectively become monopolies that artificially constrain competition. Venture capitalists refer to a "kill zone" in which they will not invest because of what is essentially a stranglehold by the tech majors. And the debate about CO_2 emissions and climate change shows that significant externalities, created by some corporations, are still not priced in markets and impose long-term costs on society.

Flawed as these two core assumptions might be in our view, Jensen arrives at a model for enlightened shareholder value maximisation that we think has some merit because his model takes into account the flaws of his basic assumptions.

Most importantly, Jensen recognises that shareholder value maximisation is a goal, but his theory provides no guidance as to how to achieve this goal. For instance, in baseball, the goal of each team in every game is to score more runs than the opposing team. But this goal can be achieved in several different ways: either better offense, better defense, or some combination thereof on that given day. This optimization problem is constrained by the fact that a team has only so much talent at its disposal. Teams can shift their defensive alignments depending on the opposing batters and their tendencies. The pitchers can alter their pitching strategy depending on the situation on the field and on the opposing batter's strengths. These changes are interdependent and require trade-offs between conflicting sub-goals, all to achieve the overarching goal of winning the game.

Jensen defines enlightened shareholder value maximisation as whatever a corporation needs to do to maximise *long-term* firm value. By adding the qualifier "long-term" into the mix, Jensen manages to integrate shareholder value theory and stakeholder value theory in an elegant way. He recognises that stock markets might be forward looking but not omniscient. Share prices might not reflect the long-term consequences of corporate actions but instead focus too much on the near term. Similarly, stock markets are typically very bad at accounting for externalities and the long-term costs these impose on society. This is because they are not supposed to take these elements into account in a share price unless a particular externality is charged to the company.

Thus, the enlightened manager recognises that maximising long-term firm value by exploiting workers, polluting the environment, or focusing only on short-term profits is impossible. Some less-enlightened managers might think that delaying the day of reckoning forever is possible, and indeed, one loophole of Jensen's definition of enlightened shareholder value maximization is that if a manager can avoid being held accountable forever, the result is the maximisation of shareholder value. We believe that this is a dangerous game to play and, in the end, not in the shareholders' best interest because in many cases—although nobody knows exactly when—these externalities will come back to stalk a company. And when the backlash comes, the share price will suffer dramatically and firm value will decline, costing shareholders—typically far more for companies with years of misdeeds in their history than for companies that tried to do the right thing. Therefore, with enlightened shareholder value maximisation, a corporation's management and board of directors must actively make trade-offs between short-term and long-term goals and consider the long-term impact of their actions when formulating a strategy.

This focus on long-term firm value maximisation has become more popular during the past two decades, and in the United Kingdom, it is now the legal foundation on which corporate leadership is assessed. The Companies Act 2006 enshrined enlightened shareholder value maximisation in UK corporate law with Article 172(1), which defines the duties of company directors as follows:

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefits of its members as a whole, and in doing so have regard (amongst other matters) to –
>
> (a) the likely consequences of any decision in the long term,
>
> (b) the interests of the company's employees,
>
> (c) the need to foster the company's business relationships with suppliers, customers and others,
>
> (d) the impact of the company's operations on the community and the environment,
>
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
>
> (f) the need to act fairly between members of the company.

Note how the law requires the directors of UK companies to maximise the benefits for members (shareholders) while simultaneously considering the long-term consequences of corporate actions and especially their effect on significant other stakeholders, such as employees, suppliers, customers, the community, and the environment. Directors who fail to live up to these standards can be sued by affected parties and face fines or even a ban from taking on future directorships if found guilty. The United Kingdom certainly is not some kind of corporate-governance paradise, yet regulators and corporate leaders alike have recognised that shareholder value can be maximised only if the impact of any decision on other stakeholders is taken into account *before* the decision is made.

Using a stylised family analogy, this approach enshrines in law the idea that the primary wage earner and his or her goals remain the most important priorities for a family. But this person must assess the impact of his or her goals and actions on other family members and take into account the long-term consequences of his or her actions. So for example, if a husband is the decision maker, he is incentivised to act based on the famous maxim of "happy wife, happy life" if he does not welcome dramatically unpleasant surprises.

Stakeholder Value Maximisation

Enlightened shareholder value maximisation is not the same as stakeholder value maximisation. In the United Kingdom, the board of directors remains the sole decision maker and is accountable to shareholders. Typically, the board of directors is devoid of both employee representation and any political interference from governments.

In fully fledged stakeholder maximisation regimes, different stakeholders are directly involved in the corporate decision-making process and, together with management and independent directors, are accountable for the corporation's actions.

The main risk of directly involving stakeholders other than the management and directors of a company in the corporate decision-making process is that it opens the door to rent-seeking—that is, the abuse of corporate resources by these stakeholders. We have shown how the United Kingdom incorporates the interests of external stakeholders into the decision process. In the past, the United Kingdom has used direct stakeholder value maximisation approaches, with terrible results. The Water Act 1973 essentially nationalised water utilities in the United Kingdom and put them under the management of regional water authorities. The members of these regional water authorities were appointed by the Secretary of State for the Environment, Food and Rural Affairs. The idea was that water utilities run for the benefit of shareholders would have an incentive to pollute the environment and—because they have a natural monopoly in the communities in which they operate—would overcharge customers for drinking water and sewage treatment.

At first, the newly nationalised water utilities paid more attention to the cost of water and the environmental impact of the actions of the utility companies. As inflation accelerated during the 1970s, however, politicians on the left increasingly pressured the water utilities to avoid hiking their charges. In response, local authorities, in their efforts to keep costs low for consumers, slowly drained the coffers of the utility companies. In an effort to keep the government from accruing too much debt, the government under Margaret Thatcher in 1979 curtailed the ability of water utilities to issue debt, which would accrue indirectly on the government's balance sheet. The result was that by 1980, investment in infrastructure by water utilities was approximately one-third of what it had been in 1970.

Underinvestment in infrastructure meant an increase in spillages and a persistent decline in water quality in British lakes and rivers. In effect, water utilities became beholden to special interest groups and political interests. And these diverging interests in turn led to a decline in the utilities' profitability and eventually a decline in their ability to fulfil their ultimate goal of providing clean drinking water and processing sewage.

Episodes like this have given stakeholder value maximisation a bad reputation. In the next section, however, we look at stakeholder value maximisation approaches that work and what we can learn from them.

STAKEHOLDER VALUE APPROACHES IN THE WILD

A prominent approach to stakeholder management of corporations is Germany's system. After World War II, Germany had to rebuild its entire economy from scratch. On the political front, and under the supervision of the occupying powers (United States, United Kingdom, France), West Germany introduced a social market system that combined free market elements with a strong social welfare system. The key to this system, which bridged the differences between the free market capitalism of the United States and the social welfare state of France, was intensive coordination between different actors. Politicians recognised that in a world where the owners of capital and the owners of labor were in a competitive relationship with each other, the differences between them could lead to significant disruptions in society. Similarly, if politicians and business leaders acted against each other, rather than with each other, both the state and the businesses would eventually suffer. This focus on cooperation (versus competition) and communication between different stakeholders is the main driving force behind Germany's business model and has been a key recipe for the country's dramatic rise from the ashes of World War II to become the world's fourth-largest economy.

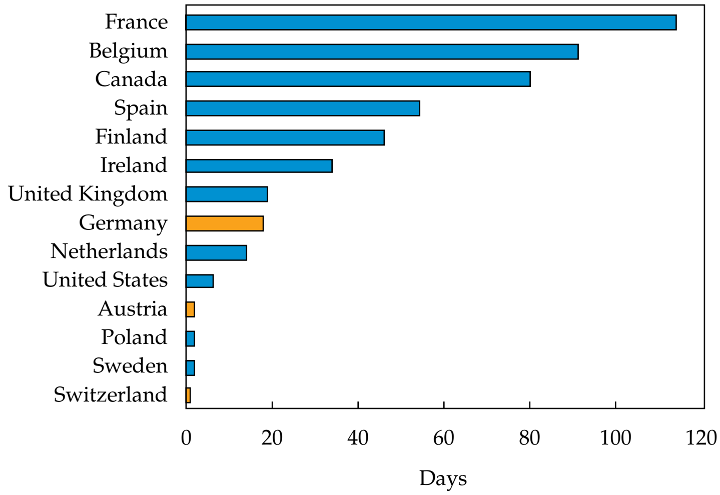
The first step toward a stakeholder value maximisation system in German corporations took place in 1951 with the Montan-Mitbestimmungsgesetz (Cooperative Management Law). This law laid the groundwork for employee representation on the boards of directors of listed corporations (Bottenberg, Tuschke, and Flickinger 2017). In 1976, the Mitbestimmungsgesetz (Codetermination Law) guaranteed employees of listed companies up to one-half of the seats on the board of directors. This employee representation on the board of directors ensures that corporate management's actions are supervised by employees of the firm and that employee interests are reflected in corporate strategy. With this employee representation, however, comes the risk of adversarial relationships and corporate capture by unions. To avoid this scenario, a legal mandate is in place for independent directors to act as a balancing mechanism (*Interessenausgleich*) among the interests of employees, management, and shareholders. In practice, this balance requires intensive communication and compromise from all participants. The culture of German boards of directors is generally one of consensus building and consensus decision making, where actions are taken only after management, employee representatives, and shareholder representatives have agreed on a common path forward.

This consensus-driven approach avoids adversarial relationships that can lead to a complete breakdown of corporate activity (see the massive strike actions in the United Kingdom in the 1970s or those in Italy, France, and other European countries throughout the decades). The occurrence of large and long-lasting strike actions by unions in Germany (as well as in Austria and Switzerland, which have similar governance structures) is significantly lower than in France or Spain, as shown in **Figure 1**. And although unionisation is higher in France (33%) and Belgium (41%) than in Germany (20%), it is by no means five times higher—even if one adjusts the data for differences in unionisation, strike rates are still much higher in France and Belgium than in Germany.[1]

Additional measures indirectly strengthened the interests of other stakeholders. For example, Germany has strict separation of management and governance. Members of a company's management board (equivalent to the executive board in US companies) are not allowed to serve on its board of directors. The role of the management board is solely to execute the strategy and run the day-to-day business. Meanwhile, the role of the board of directors (called the supervisory board in Germany) is to monitor and control a company's executives—that is, governance in UK/US parlance. By establishing a hard dividing line between executives and independent directors, the German system strengthens the power of shareholders because managers who act in a dual role on both the

[1]Jelle Visser, "Union Membership Statistics in 24 Countries," *Monthly Labor Review* 129 (January 2006): 38–49.

FIGURE 1. DAYS LOST TO STRIKE ACTION PER 1,000 EMPLOYEES, 2009–2018



Source: WSI.

executive board and the board of directors can become careless and benefit themselves rather than acting in the interest of shareholders.

Finally, German companies tend to have a more concentrated shareholder register, with family owners, banks, and other corporations having substantially larger stakes in publicly listed corporations than is typically the case in the United States and the United Kingdom. Note that shareholder concentration can have both advantages and disadvantages; it is not an unambiguous positive. Meanwhile, government ownership has been reduced to zero, except in the case of the former national telecom operator, Deutsche Telekom, of which the government owns a 14.6% stake; and Volkswagen, of which the state of Lower Saxony holds a 20% stake and controlling vetoes on corporate decisions. Overall, these blockholders have a vital interest in the respective company's long-term prosperity. This is particularly the case for family-owned businesses and businesses in which the founding family continues to hold substantial shares. These families often rely on the company's dividends and profits as major sources of income and are unable and unwilling to sell their shares. As a result, these blockholders often have a strong influence on corporate management that is more long-term oriented than that of management and smaller shareholders.

All these peculiarities of the German corporate governance system have different strengths and weaknesses. The potential strengths are (Bottenberg et al. 2017) as follows:

- a longer-term perspective on value creation and firm performance
- greater commitment of stakeholders to strategic decisions
- increased stability and resilience in crises
- higher social legitimacy of corporations and their actions
- closer cooperation between stakeholders

- anticipation of stakeholder needs and reactions

On the other hand, this stakeholder value maximisation system has its drawbacks as well:

- the potential for unresolvable conflicts between stakeholders
- higher coordination costs
- lower focus on profit maximisation, which could reduce profit growth
- dependency on the relationship between different stakeholders and their willingness to compromise
- a lack of transparency toward capital markets.

So, are the net effects positive or negative?

A recent analysis by Kim, Maug, and Schneider (2018) shows that this labor representation on boards or through workers councils acts as an insurance mechanism against unemployment. Companies operating in jurisdictions with labor representation on the board of directors cut significantly fewer employees in a crisis than companies without labor representation. On average, the authors find that companies with labor representation cut fewer than 1% of employees when an unanticipated shock hits, whereas companies without labor representation cut approximately 13% of their workforce on average, and the labor force takes one to two years to recover to pre-crisis levels. The price employees have to pay for this higher protection against unemployment is lower compensation in terms of wages and bonus payments. Interestingly, the researchers could find no differences in firm value and shareholder returns between companies with and without labor representation, indicating that this insurance against unemployment does not come at a cost to shareholders.

An influential study by FitzRoy and Kraft (2005) shows that legal changes in the German system of codetermination did not lead to lower productivity as anticipated but instead to higher productivity, thereby increasing shareholder value through higher employee satisfaction and productivity. This is by no means an isolated finding. Although the literature published in the 1980s and 1990s generally found codetermination to be detrimental to productivity and profitability, these findings were increasingly shown to be invalid and an artefact of the methods used to study the impact of codetermination on corporate profits. Instead, over the past two decades, the number of studies showing a positive relationship between codetermination and corporate profitability has grown very rapidly (Hayden and Bodie 2020).

A consensus is therefore emerging that codetermination does not negatively affect shareholder value. Instead, it improves labor relations and is thus a successful way of harmonizing the goals of one group of stakeholders (employees) with the overall goals of the company. Does this mean that codetermination reduces other forms of poor governance? Of course not. One has only to look at the Volkswagen emissions scandal to understand that employee codetermination does not solve all challenges to governance, but it certainly does improve labor relations at no measurable cost to shareholders. Whether the German system can be extended to other countries is not obvious, however—particularly for the United States, with its almost exclusive focus on shareholder value maximisation and substantially different legal system (Dammann and Eidenmueller 2020). The German system is thus neither a panacea nor a one-size-fits-all solution.

In the end, the German system of corporate governance depends, in our view, on the aforementioned three Cs: clarity, communication, and compromise:

- **Clarity:** A stakeholder-maximising approach inevitably reduces transparency for shareholders because corporate actions are often the result of a series of decisions between stakeholders, involving compromise. Moreover, some stakeholders are not accountable to shareholders. The transparency and clarity of the decision-making process and maintaining a focus on shareholders are thus of paramount importance in gaining and retaining the trust of capital markets. Stakeholder value maximisation can work only if all stakeholders are clear about their individual goals and agree, more or less, on how the corporation's goals derive from these individual goals. Furthermore, corporate management and directors need to clearly show how their actions benefit shareholders. Conflicts of interest must be either avoided completely (e.g., by prohibiting a dual mandate for CEOs as directors) or managed transparently.

  The rising trend of environmental, social, and governance (ESG) investing helps enforce this clarity and transparency in companies that are otherwise managed to maximise shareholder value. As more and more investors adopt ESG analysis in their investment process, they focus increasingly on good governance. This in turn means an increased focus on board diversity, the avoidance of dual mandates, and improved supervision of management through independent directors and best practices in audit and remuneration. The interests of employees are often addressed in the S of ESG analysis by looking at a company's wage structure (e.g., guaranteeing minimum or living wages) or the frequency and severity of workplace accidents and other hazards. The impact of a company's actions on the environment are then addressed in the E of ESG analysis, which focuses on the pollution and waste a corporation creates. The rise of ESG investing thus fosters greater transparency in corporations that make the implementation of a stakeholder value system easier and more effective and removes some of the downsides of this system.

- **Communication:** The interests of different stakeholders can be naturally divergent. Managers want to maximise profits, and in many cases, though by no means all, this goal can be achieved by cutting costs and streamlining production. Employees, on the other hand, want to earn as much as possible and thus organise in unions to improve their bargaining power. With these conflicts in place, communication between stakeholders can easily become strained and antagonistic and sometimes break down. Increased communication between stakeholders, particularly those who have worked together for a long time, can build trust and increases mutual understanding. This, in turn, fosters collaboration and transparency and enables all stakeholders to enter into compromises without losing face or feeling as though they have been taken advantage of. After all, without each other, they would all lose. Trust is the foundation of all business. Without a minimal level of trust, no customer would ever buy a product or service from a corporation, and no supplier would ever deliver raw materials to it. We have only to look at the political arena to understand how a loss of trust between different parties can create a total breakdown of the political process and prevent necessary reforms from being implemented, thereby hurting everyone.

- **Compromise:** Because stakeholder management tries to optimise a firm's long-term value while respecting the needs of different stakeholders, compromise is almost always a necessity. Rarely if ever are the interests of management, employees, customers, and other stakeholders perfectly aligned. In a shareholder value–maximising corporation, this misalignment is not a problem. Management simply does what it thinks is best for shareholders, and if employees or customers do not like the situation, they can go somewhere else. Likewise, investors could simply sell their shares, also known as divestment in some contexts.[2] Unfortunately, "going somewhere else" too often leads to short-term, not long-term, value maximisation. The need to find a compromise between the interests of different stakeholders implicitly forces a more long-term orientation on the corporation. As a result, extreme outcomes (both positive and negative) are often prevented, and the corporation becomes more stable in its development. Furthermore, compromise enables all stakeholders to buy into the corporation's goals, which is particularly important in a world where the public has become increasingly skeptical of the social value of corporations and capitalism.

Sovereign Wealth Funds as Shareholders for the Public

The perceived lack of social legitimacy of corporations' decision-making processes has led to a backlash in public opinion. From Occupy Wall Street and its slogan asserting that 1% benefit from capitalism while the other 99% do not, to the call for increased regulation of corporations and the demand for nationalisation of some corporations by left-wing politicians, clearly, a large part of the public no longer feels that capitalism, and free-market capitalism in particular, are working for them. As the example of nationalised water utilities in the United Kingdom in the 1970s shows, however, handing over corporations to politicians or other public representatives who have no interest in running a company profitably is no solution either.

How can the public participate in the benefits created by capitalists and corporate activities without endangering a firm's long-term value? The German model of stakeholder participation is probably not implementable everywhere because of cultural differences and a lack of trust among different stakeholders. If a company has paid bare minimum wages to its workers for decades and exploited its employees and suppliers wherever possible, giving them a say in the supervision of management is likely to result in retribution (which could take the form of redistribution) rather than collaboration. And this kind of retribution would invariably damage the company overall.

However, sovereign wealth funds (SWFs) can—at least theoretically—act as intermediaries that allow society to participate in the fruits of capitalism while preventing adversarial relationships from destroying a company. SWFs usually use budget surpluses (typically, but not necessarily, from the export of commodities) to achieve intergenerational equity and other long-term goals for society. As such, they are typically "owned by the people," although in practice, this phrase often means that they are governed by the ruling politicians and subject to political goals, not just long-term societal goals, which are difficult to define. Those SWFs that are captured by the political process are the

[2] Elenora Broccardo, Oliver D. Hart, and Luigi Zingales, "Exit vs. Voice," NBER Working Paper 27710 (August 2020). https://www.nber.org/papers/w27710.

ones that give all SWFs a bad reputation. More often, however, SWFs are well governed and can be a force for good. They thereby foster long-term stakeholder value maximisation in a country and benefit society.

Following the methodology of Lo Turco (2014), the primary goals of SWFs are as follows:

- **Economic stabilisation:** Reserves from the export of commodities are invested in SWFs to stabilise the government budget (and thus the entire economy) in times of adverse price swings. These SWFs typically invest in liquid assets that are uncorrelated with a country's source of wealth. Examples of such stabilisation funds are the Economic and Social Stabilization Fund of Chile and Russia's Reserve Fund.

- **Savings:** These funds aim to provide savings from the export of resources that future generations can tap into once the resource boom has ended. Examples of these savings funds are the Abu Dhabi Investment Authority and the Kuwait Future Generations Fund.

- **Pension reserves:** These funds are set up with the explicit goal of financing future shortfalls in the government pension scheme. Examples are the Australian Future Fund and Ireland's National Pensions Reserve Fund.

- **Development:** These funds are meant to invest in local infrastructure to help develop an economy and improve the general standard of living. Examples are the National Development Fund of Iran and the Mubadala Investment Company of Abu Dhabi.

- **Reserve investments:** In some cases, excess reserves need to be better managed and invested at higher rates than is possible in the government bond market. These reserve investments funds aim to achieve these goals by investing internationally in long-term projects and assets with high income and diversification benefits for the domestic economy. Examples are the Government of Singapore Investment Corporation and the China Investment Corporation.

- **National economic support:** Finally, some SWFs have the explicit goal of investing in domestic companies to protect them from foreign interference and to help them develop domestic infrastructure. Examples are the Fonds Stratégique d'Investissement in France and the Fondo Strategico di Investimento in Italy.

As a general rule, SWFs invest in liquid and illiquid (long-term) assets but strive to avoid taking controlling interests in listed corporations. The exceptions to this rule are the SWFs intended to directly support national economic champions, such as the SWFs of France and Italy. The largest SWFs are economic stabilisation, savings, and pension reserves funds. For funds with these goals, diversifying away from the domestic economy so as to act as a stabilising force when the domestic economy declines makes sense. The problem with this setup, however, is that it produces a disconnect between the ownership of the SWF by the people and its investments in other countries.

If SWFs act as a conduit to public ownership of corporations, then several investment policies need to be considered:

1. **Political independence:** SWFs that act on behalf of and for the people need to be strictly independent from political influence. Some might say that such independence is not possible, but we already have

inherently political institutions that are, at least in the ideal case, independent from immediate political influence: central banks. Although central bank officials are usually appointed by politicians and legally subject to government oversight, political influence on monetary policy is typically minimised (at least in Western countries). Similarly, although SWFs are established by governments or legislatures and subject to government oversight, the investment decisions of an SWF and how the proceeds of the investments are used need to be beyond the influence of politicians. This is already a given in the case of many SWFs, such as the Government Pension Fund of Norway and the Alaska Permanent Fund.

2. **Transparency:** As we have stated, transparency is the foundation on which to build trust. If we want the public to buy into the benefits of capitalism and corporate activities, SWFs must have transparent investment processes and holdings as well as clear guidelines of eligible investments and investments to be avoided. Transparency regarding their decision-making processes would also help.

   The Government Pension Fund of Norway is a good example of a transparent SWF. The fund employs a Council on Ethics that analyses every holding of the fund for violations of socially undesirable business practices, such as exploitation of workers or production of nuclear arms. As a result, the fund has blacklisted[3] companies such as Walmart (for breaching human and labor rights), Rio Tinto (for the severe environmental damage it causes), and Serco (because it helps maintain the United Kingdom's nuclear arsenal). This transparency helps legitimise the SWF among the public and increases the public's trust in the fund and in the claim that its activities do no harm.

3. **Domestic benefits:** A key drawback of savings and stabilisation funds is their need to invest in foreign assets. This attribute has the potential to reduce public legitimacy and buy-in because the money in the fund does not directly benefit the people who own the assets, though it does benefit the people through diversification benefits and higher, more stable returns. The fund therefore needs to have a clear policy in place to use the income and gains from its investments to benefit its owners.

   One approach is to send the owners a check with their share of the investment profits, as is done by the Alaska Permanent Fund, which sends a check to every person who resides in Alaska for at least six months of the year. Of course, the problem with this system of "helicopter money" or universal basic income is that it distributes the money indiscriminately.[4] Large public infrastructure projects will never be built by Alaskans coming together to finance them with their checks from the Alaska Permanent Fund. Thus, an alternative to sending every person a check is to use the proceeds of the SWF to finance public infrastructure projects. This is the idea behind the SWFs of France and Italy, and it has the advantage of providing resources for major public works projects that the people need but that might otherwise not be produced by the usual political process as a result of political gridlock.

[3]The authors understand that blacklisting, or excluding "undesirable" businesses, fails as a strategy for improving corporate governance because it concentrates ownership among shareholders who accept the "undesirable."

[4]See Michael S. Falk, "Income for Everyone?", in *Get to Work… on OUR Future*, 77–94 (CreateSpace Independent Publishing Platform 2019).

Finally, in an ideal world, SWFs could become a major shareholder in domestic publicly listed corporations and act there as the voice of the people. This scenario would open up domestic corporations to a more stakeholder value–oriented model that ensures management actions are evaluated with the greater good in mind. At the same time, because SWFs are professionally managed, they can influence management without triggering the feelings of resentment that so often dominate the relationship between corporate management and employee representatives or government entities—because the SWFs would simply be acting according to their societal mandate. As a result, emotions are kept at bay and compromises are easier to forge. The crucial point in this case, however, is that an SWF needs to be politically independent to prevent political goals from superseding the overall goal of long-term firm value maximisation.

Government-run entities are typically poorly run. By investing in domestic listed corporations and being active shareholders engaged with corporate management on behalf of the public, however, SWFs can become the missing link that helps build trust in capitalism and ensures the increased legitimacy of corporations in the public eye. The German model of constructive collaboration between different stakeholders might be a bridge too far, culturally or politically, in more shareholder-oriented countries such as the United States. Nevertheless, as public entities that invest with a long-term horizon and represent public (as opposed to political) interests, SWFs could be the major driving force of a rejuvenation and acceleration of capitalism in a world where so many people have become disillusioned with it.

What about countries that do not have or will not set up an SWF? Would such an absence connote generational narcissism, poor governance, opposition to sustainability, or too little money? We do not know in the abstract, but we think every country with the economic ability to establish an SWF should do so and have it act in the public interest. How this could be done in practice is the focus of the next section.

STAKEHOLDER "WHAT IFS"

In this section, we explore ideas to bolster Milton Friedman's "open and free competition" and "rules of a fair game." And we cannot think of any better primer for those ideas than the following quote from Lewis Carroll's *Alice's Adventures in Wonderland* (1865):

> Alice laughed. "There's no use trying," she said. "One can't believe impossible things."
>
> "I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."

Six impossible ideas we do not have. However, we offer four improbable, yet possible, ideas to ponder.

1. What If Stakeholder Governance Were Designed?

Governance, expressed simply, refers to those who have the right to decide and how they will exercise that right. We can design governance that offers benefits from "the wisdom of crowds":

- Wisdom begins with a diversity of opinions, and our three potential "internal" stakeholders (clients are external), the EOS (employees, owners, and society), can have very distinct views. The S potential will become clearer in the fourth what if.

- The aggregation of stakeholder votes matters, as does how those votes count; an aggregation would give each EOS group its own vote. First, each group's vote would be determined by a simple majority within the group. Second, for a vote to pass, two out of the three groups would have to pass it. If only two of the EOS groups exist, they must agree for a vote to pass. The groups' votes are transparent, but those of the individual participants are anonymous.

- To best leverage different views, each one needs to be represented independently. All the different views should be gathered anonymously and listed. Then an anonymous poll is taken and the poll results recorded. After all the views are discussed and debated, a second anonymous poll is taken to determine the final decision. All votes by voting groups are to be recorded, including any changed votes, for future review and learning.

- Decentralization, which is helped by the voting groups, is important to help avoid a decrease in the diversity of the groups' opinions and to discourage bias from creeping in.

- Trust is necessary, and this process helps facilitate trust between stakeholders.

Governance decisions should embrace "wisdom"; however, determining which decisions would use the stakeholder approach should be done separately. Just as a board has certain decision rights while management has others, the EOS approach might mimic board decision rights, perhaps with a few extensions.

2. What If Competitive Dominance Had Limits?

If a business grows to be 10% of its sector or more (out of the 11 broad economic sectors that exist today in terms of market capitalization), then the competitive landscape has changed. To help bolster open and free competition, upon achieving that 10% level of success, and until and unless the business falls below a 7% level within its sector, the business would be prohibited from the following:

a. Making acquisitions that exceed 0.5% of the acquirer's market capitalization, as measured by rolling five-year periods

b. Making stock buybacks. "The investment theorist Peter L. Bernstein proposed, half tongue-in-cheek, that companies should have to pay out all their net income in dividends (or use it to repurchase stock). If they needed money to expand, they would have to get investors to buy new shares."[5]

Much to Milton Friedman's chagrin, corporate executives sometimes spend money that belongs to shareholders on their own pet projects—the reason why he was 100% pro-shareholder as a defense to public companies spending corporate dollars to peddle influence. All corporate lobbying, political, and charitable dollars should be required to be clearly displayed on the home page of a corporation's website. "Clearly" means that no clicks or scrolling would be needed to view the spending. The information displayed should be (1) the trailing 12- and 48-month dollars spent, (2) the equivalent dollar percentage as related to both the corporation's net income and total taxes paid for those periods, and (3) the

[5]Jason Zweig, "The Hidden Risk When You Own Stocks for the Long Run," *Wall Street Journal* (15 March 2019). https://www.wsj.com/articles/the-hidden-risk-when-you-own-stocks-for-the-long-run-11552662001.

most recent 12-month year-over-year percentage change in spending. These disclosures are meant to aid transparency (and maybe serve as a disinfectant, too) for the public and the corporation's employees, who might not even know what their employer has been doing with cash flows.

3. What If More Employees Had "Ownership"?

Imagine that all employees who reach a full-time tenure of five years, for example, receive participation shares. The number of shares granted would be based on employees' wage compensation as a percentage of the aggregate wage compensation of the middle 60% of all who qualify. These shares would come with both voting and dividend rights. The dividends would be paid in the form of a bonus. The shares would be neither saleable, transferable, nor owned beyond employment. The total participation shares count would be capped at a theoretical 30% of the total outstanding shares.

Now, imagine the following:

- Wage reductions could be less likely, with votes against them. Wage increases would not become more likely because of the harm they would do to potential dividends.
- Wage inequality could be reduced through higher incomes.
- Productivity could improve with the success incentive.
- Expense management could improve because of the desire for dividends.
- Working conditions and safety could improve, if need be, in response to the new "voice."
- Strategic planning could improve because of the broader inclusiveness.
- And dividends would gain in popularity, versus buybacks.

Might a more sustainable business be the result? We can imagine improved sustainability ratings and a positive boost in public market exposure.

A by-product of all this—keeping in mind the maxim that generating positive cash flows and covering costs is everything—is that management would have less capital allocation flexibility. But before you think that is not a positive by-product, keep in mind that corporate acquisitions have a very poor track record, stock buybacks are financial engineering as well as support for stock option giveaways, and reinvestments overall have been dropping.

4. What If Society Had Partial Ownership of Companies (in addition to its income tax share)?

Although capitalism has done more for people than any other economic system before it, unfettered capitalism has limits. Imagine a football game with no referees: It would likely be a free-for-all. The move from a shareholder focus to a stakeholder one is a big step in the right direction—dare we say the addition of vested referees will help? We do not propose doing away with capitalism.

Given that society, both local and global, can be a stakeholder—remember the externalities—we should seemingly welcome such voices to the table as vested, independent opinions. Once a company reaches top-line inflation-adjusted (2020 base) revenues of $500 million, it would grant a 5% restricted stock position to the jurisdictional SWF. If no SWF exists, then why not use this idea to establish one?

The SWF would receive voting rights (as one of the three EOS groups) and be run by an independent, professional fiduciary. In exchange for SWF shares, companies would receive an exemption that lowers the taxability of their dividend payments; dividends would become more tax friendly than capital gains. Participation-share cash dividends (special bonuses) would, as a result, be eligible for the same advantaged tax status.

SWF goals would be, by their nature, oriented in favour of longer-term and externality-oriented types of risk.

IS CAPITALISM FOR EVERYONE A RADICAL IDEA?

Imagine if we had said at the outset of this piece that we advocate for government entities to take substantial stakes in private companies for the benefit of the public. Imagine if we had said that we advocate for employee representation on boards where possible. Would you have read further?

We are both avowed capitalists, yet we recognise that capitalism, practiced as pure shareholder capitalism, is flawed. But this does not mean that we should fight capitalism or abolish it in favour of some other, possibly untested, economic system. Capitalism has been the most successful economic system in history. It has created more wealth and lifted more people out of poverty than any other economic system.

We do not need to abandon capitalism: We need to reform it to make it more inclusive. Because if we do not, societal trust in capitalism will continue to decline, the attacks from the populist left and the populist right will increase, and eventually, its opponents might break it—which could cause significant harm for billions of people worldwide.

The simplest and most straightforward way to make capitalism more inclusive—to in fact bring about capitalism for everyone—is to take into account the interests of all stakeholders. And we think the best way to do this is to give these stakeholders a seat at the tables of capitalism, right in the boardroom. Giving employees representation on the board of directors might sound radical, but it has worked in Germany for decades—and it can work in other countries as well. Giving the general public (not only public shareholders) a stake in each listed company above a certain size might sound like a wild idea, until you realise not only that SWFs already do this in many countries but also that these entities can be successfully shielded from political interference.

We hope that in this note, we have shown that our ideas are not radical, unrealistic, or destructive but instead are unconventional, realistic, and constructive. Obviously, people will disagree with us on both the details and the principles underlying some of our ideas. That is a good thing. Our intent here is not to provide ready-made solutions but to contribute to an ongoing discussion and to get people thinking about the possibilities open to us.

Capitalism, in our view, has a bright future if we can make it more inclusive. But if we fail to do that, we will all pay a price.

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