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What Should Corporations Do?

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CHICAGO – With the COVID-19 pandemic reinforcing concerns about economic inequality, left-behind communities, discrimination, and climate change, there is increasing pressure on corporations to do more than sell a good widget at an affordable price. Responding to the changing public mood, the US Business Roundtable declared last year that, “Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities, and our country.”
But this way of framing the issue is unhelpful. A corporation’s stated objectives should help guide its choices. If all stakeholders are essential, then none are. In an attempt to please everyone, the Business Roundtable will probably end up pleasing no one. Recent evidence even suggests that the corporations that signed on to the group’s “stakeholder capitalism” statement have been more likely to lay off workers in response to the pandemic, and less likely to donate to relief efforts.

Nevertheless, is the shareholder-centric view propounded by Nobel laureate economist Milton Friedman wrong? Friedman’s rationale was that because managers are employed by shareholders, their duty is to maximize profits – and thus the share price – over time. While this approach was widely embraced by corporate executives in the United States and the United Kingdom over the past 50 years, its basic logic was misunderstood. To many observers, the idea that businesses should favor millionaire investors at the expense of long-term workers is appalling.

Yet there is a deeper argument for Friedman’s view, based on the recognition that managers will not necessarily squeeze everyone else to favor shareholders. Because shareholders get whatever is left over after debt holders are paid their interest and workers their wages, management can maximize shareholders’ “residual claim” only if it expands the size of the corporate pie relative to these prior fixed claims on it. To the extent that management must satisfy everyone else before looking to shareholder interests, it already does maximize value for all those who contribute to the firm.

True, some would counter that the imperative to boost quarterly profits leads to cost cutting in areas like worker training. But if companies want to maximize their

shares' value over the long term, they will train workers where needed, encourage sustainable practices from their suppliers when it reduces costs, and foster lasting relationships with customers instead of ripping them off. Put another way, even if CEOs do focus primarily on share prices, that doesn't mean the stock market only rewards actions that boost this quarter's earnings. Amazon showed little profit for years, but is thriving now precisely because it invested so much in its business.

Moreover, when quarterly results do affect share prices, it is often because the short term has been interpreted as a credible reflection of the long term. By the same token, instead of trying to boost short-term profits by sacrificing the long term, corporate managers would do better to explain their strategy and encourage investor patience. And if market analysts do not buy their argument, perhaps they have a point, and new management may be in order. It is up to good corporate boards to decide, without being swayed by meaningless short-term results. They can certainly encourage managers to take a longer-term view. Vacuous statements about serving all stakeholders need never be issued.
To be sure, corporate managers have misused Friedman's original formulation to justify ever-increasing pay denominated in stock, which they claim "aligns" their interests with shareholders'. But this reflects a failure of corporate governance, not fundamental objectives. The real problem with Friedman's formulation is that no matter how correct it is technically, the fact that it is misunderstood makes a difference: Today's idealistic workers and customers refuse to accept it. The ironic implication of this attitudinal shift is that corporations that announce a commitment only to maximizing shareholder value risk driving away key constituencies, which will be reflected adversely in their share price.

This is why, as a recent McKinsey & Company report shows, more corporations are becoming "purpose-driven." Among the benefits they claim are stronger revenue growth (by attracting socially conscious customers), greater cost reduction (such as through energy or water efficiency), and better worker recruitment and motivation (making "doing good" an employment perk).

Of course, none of these targets is at odds with the objective of maximizing shareholder value. Corporate purpose is useful only insofar as it enthuses critical constituencies. If purpose is meant to please everyone, however, it will introduce an impossible standard and backfire. The key is for management to make clear how it will choose between different constituencies when trade-offs must be made.

For example, when Google withdrew from a US government program to develop artificial intelligence for military purposes, it signaled that its employees' objections were more important than the interests of a large, lucrative client. As a result, Google employees and customers all have a better sense of how the company weighs their interests, and that clarity will be beneficial in the long run, including to its share price.

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Some corporations have taken things even further, such as by developing sustainability guidelines for themselves and their suppliers in the absence of state regulations. Collective acts of corporate *noblesse oblige* are worrisome: guidelines that large players can easily meet may keep out smaller market entrants, and nobly intentioned buyers may form “cartels” to squeeze suppliers. As such, it would be better if corporations pressed elected governments to regulate, rather than acting on their own.

Finally, there is the growing issue of corporate political influence and speech. Many stakeholders now want companies to weigh in on issues such as the restrictions on LGTBQ rights in some US states. These are often the same stakeholders who object to corporate money influencing elections. Generally speaking, interventions outside a company’s business interests raise profound questions of legitimacy: Whose views are being represented? Management? But managers were appointed for their competence to run the firm, not for their political views. Stakeholders? Which set and on what basis?

Corporations should be careful here. While we have political processes to reward or penalize government actions, and corporate processes to hold managers accountable, we lack robust mechanisms for monitoring and checking businesses that take on traditional government roles. Until we do, corporations that assume public responsibilities risk crossing the limits of public acceptance. Better to let sleeping dogs lie.

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