

Afternoon Keynote

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OPPORTUNIST SHAREHOLDERS SHOULD EMBRACE COMMITMENT

Limited-liability, privately-owned joint-stock companies are the core institutions of modern capitalism. These entities are largely responsible for organising the production and distribution of goods and services across the globe. Their role is both cause and consequence of the revolution in the scale and diversity of economic activity over the past two centuries.

So how should we think about these hugely important entities? To answer this question, I will address four narrower ones.

- Why do companies exist?
- What is the purpose of companies?
- What should be the goal of companies?
- Who should control companies?

Why do companies exist?

Why do we have limited liability companies? The answer is that if one wants to organise production and sales of complex products and services, a (semi)- permanent institution may outperform an array of small businesses that have to deal with one another through markets. As the late Ronald Coase taught us, companies exist because, hierarchy – “command and control” – frequently beats markets. Companies exist because markets have limits where complex, long-term planning is required.

The advantages of companies derive from the costs of creating and monitoring a vast set of detailed contracts under irreducible and inescapable uncertainty. Organising many vital economic activities require the scale of an army and the longevity of a tortoise.

A life insurer is of limited use if one cannot be sure that it will 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 lifetimes. A car manufacturer is likely to be of little use if it is unable to use what it has learned from today's models in making tomorrow's.

The *raison d'être* of the company - its ability to commit for the long term - means that it is built upon relational, or implicit, contracts, contracts that, by their very nature, cannot be fully specified.

Why do we have to rely on implicit contracts? Long-term commitments could in theory be managed instead by trying to specify every eventuality. But this would be inconceivably complex and costly. It would also come up against the deeper problem of uncertainty. We have little idea of what might happen in the next few months, let alone the next few decades. In other words, companies are a partial solution to the reality of what economists call “incomplete markets”.

A company's implicit contracts say, more or less, that the company will purchase one's services for a more or less indefinite period, the company will look after one, and, in return, one will do what the company tells one to do. The genius of the limited liability joint-stock company then was to achieve vital economic ends by importing the hierarchical structures of older institutional forms – civil bureaucracies or armies – within the market economy.

In order to make these entities work, one needs vast amounts of capital. In the beginning, that money is mostly provided by shareholders. They would not provide it without the benefits of limited liability, partly because they know they cannot control management effectively. Thereafter, it mostly comes from retained earnings and borrowing.

In return for providing risk capital, shareholders are entitled to the stream of corporate profits, whether these are paid out (as dividends or share buy-backs) or are retained and reinvested by the company. If things go well, shareholders have a profitable investment. But, under limited liability, if things go badly, they lose no more than their investment.

What is the purpose of companies?

Let me turn to my second question. What is the purpose of companies? The answer is that it is an institution intended to generate economic value. That is its social purpose. It is the function of any and all companies, subject to an important proviso: the company should not seek to add economic value by inflicting negative externalities, such as environmental degradation.

Society has given the corporate form important privileges. In return, society has a right not only to expect obedience to the law, but decency: even if it were not illegal, dumping toxic waste or rigging one's affairs so as to pay minimal taxes to the jurisdictions that provide the profits is indecent. It is freeloading.

A company should, in sum, add value to those who engage with it. It does so by organising its 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.

What should be the goal of companies?

Now, turn to the third question: what should be the goal of companies? Unfortunately, we have accepted a simplistic answer to this question: "maximisation of shareholder value".

An obvious difficulty is that if companies are allowed to make the maximisation of shareholder value their sole goal, they can (and will) argue that they are not just allowed, but even obliged, to do whatever they can expect to get away with. But these are the values of a psychopath. They would destroy the trust on which civilised society is built.

A company aiming solely at maximising shareholder value might conclude it would be its duty to cheat its customers, abuse its staff, or pollute the air and water if it is allowed to do so (or at least not prevented from doing so). Such a company might use its resources to obstruct an appropriate regulatory response to such (mis) behaviour. The only check on such behaviour would be loss of reputation. But that is a slender reed. If we believed this is how companies think, many potentially valuable transactions would never be made.

Shareholder value maximisation is at the least a radically incomplete goal. Ethical restraints must be internalised, even if they are against the interests of shareholders, for the good of society as a whole.

Who should control companies?

Now turn to the last and most significant question: who should control companies? The economic argument for shareholder control is that, while all other stakeholders are protected by contract, shareholders are not. They therefore bear the *residual risk*. This being so, they need to control the company in order to protect their interests.

A practical argument against such shareholder control is that shareholders are unable to exercise it effectively. The main difficulties here are the combination of asymmetric information (generally, shareholders are ignorant outsiders) with conflicts of interest (generally, shareholders of public limited companies are agents, not principals, and too often they are closer to the management of companies than to their principals) and collective action problems (generally, individual shareholders own a very small share of the company, which means that their efforts at improving governance are shared very widely).

Thus, no less a figure than Adam Smith, founder of modern economics, argued: "Negligence and profusion . . . must always prevail, more or less, in the management of the affairs of such a company." His concern here was over the "agency problem". Indeed, it is clear that management, often in place for a short time, may well loot companies for their own benefit, with malign consequences for the company and the economy, as Adam Smith feared.

This agency problem is likely to become even worse under shareholder value maximisation. In principle, this should mean the maximisation of the present value of the company's earnings to infinity. In practice, when dealing with inescapably ill-informed shareholders, managers find it all too easy to manipulate the share price, at the expense of the longer-term future of the corporation.

Yet a still more important argument against shareholder control does exist. While shareholders do indeed bear risks in their role as insurers of solvency, they are *not* the only stakeholders to do so. A host of others are also exposed to risks against which they cannot be protected by contract – *indeed, that is the whole point of the company*. Among such groups are long-term workers, long-term suppliers and the jurisdictions in which companies operate. All are likely to suffer long-term damage if a company – particularly a large company – fails. Was Detroit vulnerable to the failure of General Motors? Yes, it was. Were long-term suppliers to General Motors vulnerable to its failure? Yes, they were. Were long-term employees and pensioners of General Motors vulnerable to its failure? Again, yes, they were. It is simply false to argue that shareholders and shareholders alone bear the residual risks of companies.

Moreover, shareholders, unlike the others, and particularly unlike employees, can readily hedge their risks by diversifying their portfolios. A worker cannot normally work for many companies at the same time and, other than in exceptional circumstances (professional sports, for example) nobody may own tradable shares in other people, except via taxation.

The doctrines of shareholder value maximisation and shareholder control allows us to pretend that the creation of limited liability companies has not changed the market economy in any fundamental way. But, as Colin Mayer of Oxford's Saïd Business School argues in his book, *Firm Commitment*, this misses the true purpose of the company – the creation of economic value in the long run. To deliver on those purposes, he argues, companies must sustain long-term commitments. But such commitments will only endure if it is costly for parties to be opportunistic. Moreover, it is often in the interests of all parties to bind themselves not to behave in an opportunistic way. But, with the control rights of shareholders on sale to the highest bidder, such commitments cannot be made. Those who make the promises might disappear long before they can deliver.

If people are to make long-term commitments, trust is the only alternative. But a company whose goal is whatever seems profitable today can be trusted only to renege on implicit contracts. It is sure to act opportunistically. If its managers did not want to do so, they would be replaced. This is because, as Prof Mayer argues: "The corporation is a rent extraction vehicle for the shortest-term shareholders." Aligning managerial rewards to shareholder returns reinforces the opportunism.

In practice, many capitalist economies do mitigate the risks of a market in corporate control. This is true of continental Europe, notably Germany. But it is also true in the US, where the idea that management should be protected against shareholders is accepted in practice, if not in theory. The country that has taken the idea of shareholder control furthest is probably the UK.

Prof Mayer argues that: "The defect of existing economic models of the corporation is in not recognising its distinguishing feature - the fact that it is a separate legal entity. The significance of this stems from the fact that it is thereby capable of sustaining arrangements that are distinct from those that its owners, its shareholders, are able to achieve."

It is, in other words, in the shareholders' interests *not* to control companies completely. They need to be able to tie their hands. Mayer's suggested solution is what he calls a "trust company", one with explicit values and a board designed to oversee them. He justifies such a radical switch with his scepticism about the feasibility and effectiveness of regulation.

Less radical would be to encourage companies to consider divergent structures of control. One might be to vest voting rights in shares whose ownership can be transferred only after a holding period of years, not hours. In that way, control would be married to commitment. One could also vest limited control rights in some groups of workers. This is not to argue that committed long-term ownership is always preferable. Family control, for example, has both weaknesses and strengths.

We have to recognise the trade-offs in managing and governing these complex, long-lived institutions. We should let 100 governance flowers bloom. Different models of control and governance are likely to work best for different sorts of companies. But the canonical academic model of the past few decades is unlikely always, or even frequently, to be the best.

Conclusion

In the words of the great H. L. Mencken, "To every complex problem there is an answer that is clear, simple and wrong." The governance of corporations is an extremely complex problem, because of their nature: they are in the market economy, but not of it. Shareholder value maximisation and shareholder control are clear and relatively simple answers to that problem. Unfortunately, they are also wrong.