Corporate Objectives

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Seminario Anual de Investigación
CIES 2020, December 15

- What is the appropriate objective for a firm, particularly a public company?
- The traditional view both in finance and law is that a company should act on behalf of its shareholders.
- But recently, many have disagreed, arguing that companies should take into account the interests of stakeholders as well.
- The Business Roundtable in the U.S. is among those adopting this position.

- This view seems to fly in the face of another idea that many subscribe to: freedom of contract.

- Just as parties should be able to write the contracts they like unless there are third party effects (externalities), so founders should be able to set up companies as they wish.

- There is nothing to stop a founder from setting up a company as a worker or consumer cooperative or a non-profit if he or she wishes, or specifying that workers should be on the board.

- But most public companies are not set up in this way. Shareholders have the votes and no-one else does. In this case it is hard to argue that the company is not meant to act on their behalf.

- Many finance and legal scholars have drawn the conclusion that companies should maximize profit or (long-run) market value.

- As Milton Friedman famously wrote in 1970: “[The] responsibility [of a corporate executive] is to conduct business in accordance with [shareholders’] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.”

- But it turns out that this conclusion doesn’t follow once one recognizes that shareholders are “ordinary people”, who have social as well as monetary goals.

- (In the case of institutional investors I am thinking of those who invest in the institution.)

- For example, shareholders (consumers) buy electric cars rather than gas guzzlers, use less water in their house or garden than is privately optimal because water is a scarce good, buy fair trade coffee even though it is more expensive and no better than regular coffee, buy chicken from a free range farm rather than a factory farm.

- But if shareholders are willing to take social factors into account, and internalize externalities, in their private lives, why would they not want the companies they invest in to do the same?

- Friedman argued against this, but he was thinking of charitable contributions, where money-making and social activities are separable: a company has no comparative advantage in undertaking them.

- His conclusion is no longer valid if money-making and ethical activities are inseparable.

- Consider a retailer that sells military-style rifles in its store. If shareholders are concerned about mass killings, transferring profit to shareholders to spend on gun control might not be as efficient as banning sales of the rifles in the first place.

- Or consider whether a company that can (legally) make a profit by polluting a lake should do so. Friedman’ s argument again fails: the cost of cleaning up the lake may far exceed the foregone profit from not polluting the lake in first place.
- Cf. Texaco’s oil extraction in Ecuador.
- None of this would be a problem if we could rely on national/international governments to internalize externalities…

- How can shareholders push firms to act in a socially responsible manner?
- There are two main mechanisms: voice or exit (Hirschman)
- Voice refers to using their voting power or engaging with management in other ways.
- Exit refers to divesting from “dirty” firms, hoping this will persuade them to become clean.

- Consumers/workers can also pursue an exit strategy by boycotting the product of/refusing to work for dirty firms.
- I will spend most of the remaining time on voice and then say a few words about exit.

- <u>A very simple 3 date model</u>
- Consider a company initially 100% owned by a founder F.
- At date 0 F will take the company public and sell off her entire stake to a large number of (risk neutral) shareholders.
- The company is expected to make profit equal to 100 at date2.
- The price of the shares at date 0 will therefore be 100 (assume a zero interest rate).
- At date 1 to everyone's surprise it is learned that climate change is a problem and that this company will cause environmental damage equal to 30.
- Suppose there is only a small direct effect on the shareholders themselves.

- The company can avoid this damage by spending 20.
- The question is whether to do it. (A benevolent planner would.)
- Imagine that this is decided by a vote of the date 1 shareholders.
- Suppose that each shareholder is somewhat socially responsible in the sense that when she makes a decision she puts weight λ on the welfare of other people affected by the decision.

- $\lambda = 0$ purely selfish, λ =1 pure altruist

- Mask example: cost to me =10, benefit to you=50

Put on mask ⇔ -10+50 $\lambda > 0$

⇔ λ>1/5

- Emphasize: we are assuming that people are consequentialists

- Back to the vote.
- Suppose each shareholder votes as if she was pivotal. (Reasonable.)
- Consider someone who owns a fraction θ of the firm.
- A clean outcome costs this shareholder 20 θ (capital loss)
- It costs fellow shareholders 20(1-θ) (capital loss)
- It reduces environmental harm by 30
- So vote clean as long as -20 $\theta + \lambda$(-20(1-θ)+30)>0

Vote clean as long as

- -20 $\theta + \lambda$(-20(1-θ)+30)>0

$\Leftrightarrow \lambda > \frac{20\theta}{10+20\theta}$

If θ is small this will hold as long as λ>0!

- Conclusion: well diversified shareholders will vote for the socially efficient outcome even if they are only slightly socially responsible.
- Turns out to be a general result.
- Not true for a large shareholder. If θ=1, need λ>2/3

- Divestment much less effective than voice.

- Need a more elaborate analysis to show this.
- The mechanism is that if people divest from dirty firms the share price will fall, raising the cost of capital. Value-maximizing managers or managers who want to raise capital will therefore be induced to become clean.

- The problem is that when an investor divests others will buy her shares without much of a price reduction and so the the cost of capital will not change much.

- For this reason it’s hard to get a lot of people to divest: their impact is small and they lose something.
- For details, see Exit vs. Voice (with Eleonora Broccardo and Luigi Zingales) on my website.

- Empirical evidence is consistent with this. Teoh et al. (1999) study one of the broadest divestment campaigns --the one against the apartheid regime in South Africa-- and find no impact on stock prices.
- Preliminary conclusion: voice works better than exit.

Qualifications

- Exit can be effective if a campaign changes people's information or preferences (they are no longer consequentialists).

- More likely with consumer boycotts than divestment.
- Examples
  - Black Americans' boycott of buses in Montgomery, in 1955
  - The fur-free campaign by the Humane Society
- Voice can be easily restricted.
- In the U.S., shareholder proposals are not binding and management can prevent a proposal from appearing on the ballot by invoking the "ordinary business operations exception."
- Voice is also infeasible if somebody owns a majority of the votes (Facebook) or the company is private (Koch Industries).

Implications

- Nonetheless:

- Institutions like Harvard might want to rethink their strategies…
- Perhaps New York State has a better approach: New York State's comptroller, Thomas DiNapoli, announced on December 9, 2020 that the state would begin divesting its $226 billion employee pension fund from gas and oil companies if they can't come up with a legitimate business plan within four years that is aligned with the goals of the Paris climate accord.

- Regulatory authorities might want to make voice easier to express.
- Companies might want to consult their owners about what they want.

- An alternative:
- Companies can adopt mission statements, preferably at the time of incorporation.
- Examples of this are B Corporations in the U.S. or “Empresas B” in Peru.

- Whichever approach is adopted—consultation or mission statements—the corporate landscape is changing.

- It is no longer accepted by many if not most people that, to paraphrase Milton Friedman, the only social responsibility of a business is to make money for its owners.

- Thank you!