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Is Big Business Destroying The Fabric Of America?

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In this strangest of all election years, Big Business is taking a shellacking. It's not just from Bernie Sanders, the Democratic socialist, who says that big corporations are "destroying the moral fabric of America."

The leading Republican candidate, Donald Trump, has attacked Apple, Ford, Kraft Foods and Carrier for exporting jobs and explains from his own personal experience how Big Business corrupts politicians. Meanwhile Ted Cruz, the Republican runner-up, crusades against corporate welfare and crony capitalism. Hillary Clinton has also made significant shifts, distancing herself from international trade agreements and promising tohold any wrongdoers in corporate America accountable.

Trump and Sanders are drawing huge crowds and entertaining them with their respective explanations of how "the system is rigged." The underlying theme is similar— the average person can no longer get ahead just by working hard—even if the recommended actions differ. The message is resonating widely, essentially because voters can the evidence for it with their own eyes and from their own experience.

And it's not just politicians who are critical. The business-oriented Cato Institute is also calling for "an end to crony capitalism that costs taxpayers $100 billion year and consumers hundreds of billions more in higher prices."

The massive Big Business phenomenon of share buybacks—some $3.4 trillion over the last 10 years—has been denounced by such stalwarts of capitalism as Harvard Business Review ("stock price manipulation"), The Economist ("an addiction to corporate cocaine") and Reuters ("corporate self-cannibilization").

Mainstream economists like Larry Summers say that international trade policy "is a project being carried out by elites for elites, with little consideration for the interests of ordinary people" and David Autor points out that trade agreements have had wider and long-lasting negative consequences than were previously understood.

Why Doesn't Big Business Fight Back?

"Everyone is bashing Big Business," wrote Bloomberg Businessweek in February. "Why won't they fight back?" Some CEOs are speaking out and suggesting there's no real problem. Jamie Dimon's letter to JPMorgan's shareholders makes no secret of his belief that when it comes to banking, "big is beautiful," and in effect, to hell with the effort to end "too big to fail."

GE has also taken up the challenge in response to Bernie Sanders, who cited GE as an example of what's gone wrong. Jeff Immelt, CEO of GE, has written a Washington Post editorial defending GE that ends by saying that Bernie Sanders "doesn't get the point."

Yet after reading Jamie Dimon or Jeff Immelt, one has to wonder whether it isn't Big Business that "doesn't get the point." "Fighting back" by denying that there is a problem may not be the best way to go when there are obvious, serious, widespread economic anomalies that cannot be dismissed as mere populist politics or voter ignorance.

Some of the presidential candidates may be going away soon, but the voter anger and the carefully researched critiques of Harvard Business Review, The Economist, Reuters, the Cato Institute and the mainstream economists are not. Big Business needs to recognize that there is a problem, understand what it is, and then play a constructive role in fixing it.

An Economic Problem, Not Just A Moral Problem

The first step towards understanding the situation is to recognize that we have in the first instance an economic problem. Contrary to what economic theory would predict, the wages of average citizens have been stagnating for a number of decades. Despite a soaring stock market, we live in a period of "secular economic stagnation." Until we understand why this is happening, with a clear comprehension of "who is doing what to whom," we will never be able to assess whether the conduct involved is moral or immoral, let alone whether it is destroying the fabric of America.

Let's also recognize that the macro-economists have not been terribly helpful to date in shedding light on the problem of "secular economic stagnation." Talk among macroeconomists like Larry Summers or Ben Bernanke of a "savings glut," a "failure of demand" or "supply chokes" are descriptions of what is occurring, but they offer little diagnostic insight into why the problems are occurring, let alone how to fix them. Suggestions by economists like Thomas Piketty that we should try to solve the problem of growing inequality simply by "taxing the rich" run the risk of making economic stagnation even worse.

Conduct Ahead Of Consequences

Another step towards clarifying the discussion involves distinguishing between the *conduct* that is causing stagnating wages and the economic *consequences* of that conduct. Thus angry voters—and Bernie Sanders—are infuriated by consequences: stagnating incomes for most workers over several decades. But they are often not well informed about the economic actions that have led to stagnating incomes. One reason for that is that they haven't always studied the practices of Big Business in detail. Another is that a lack of transparency has been deliberate on the part of Big Business, so that even for those who try to understand, it's often tough to figure out what's going on.

Donald Trump for instance has been explicit about his involvement in twisting the political system for his own financial benefit over the years and even presents this as one of his strengths as a presidential candidate. He is arguing in effect that "it takes a thief to catch a thief." His extended involvement in crony capitalism is one reason why we are unlikely ever see his tax returns: they may reveal the shocking extent to which he has been able to lower his tax bill by various legal but arcane maneuvers.

We should therefore give weight to those who have taken the time to understand the behavior of Big Business, either by having participated in it or by having studied the subject, like scholars who write for Harvard Business Review, The Economist and Reuters.

Why Are Incomes Stagnant?

A useful starting place for the inquiry is to examine the relationship of workers' incomes and productivity. Big Business likes to talk about the good jobs it provides but the reality is that median salaries in the US have been flat for several decades. This is not because of a failure of workers to become more productive. The truth is that there were gains in productivity but they did not go to workers. Gains that flowed from workers' improvements in productivity mostly flowed to the organizations and their shareholders, including the executives who received sizable stock-based compensation. Hourly compensation for workers remained practically flat.

Whereas in the period 1950-1980, workers' hourly compensation advanced roughly in step with improvements in productivity, after 1980 that changed and most of the gains were retained by the organization and its shareholders.

This was no accident. It was an explicit decision by Big Business. Beginning in the 1970s and 1980s, many U.S. firms responded to the unprecedented changes taking place in the world—deregulation, globalization, the emergence of knowledge work, new technologies, and later, the Internet—by adopting a different idea about the purpose of a commercial firm. The idea was that the primary purpose of a corporation is to *maximize shareholder value as reflected in the stock price*. As the idea appeared to offer a simple, clear and measurable tool for resolving baffling business challenges, it was—and still is— widely embraced by Big Business. Reinforced by stock compensation for senior executives, shareholder value thinking led to firms putting all of their efforts into raising their stock price in the short term through cost-cutting, often at the expense of investment and innovation and holding down compensation for workers.

This was combined with massive stock price manipulation through share buybacks, which meant that often the firm itself suffered at the hands of executives and activist hedge funds. The *Financial Times* has called it "an overwhelming conflict of interest." Yet the practice is increasing, with some $1 trillion returned to stockholders over the last year.

The result is that much of Big Business is focused on extracting value from the firm for shareholders, often at the expense of customers, workers and even the firm itself. Since behind a façade of financial engineering that creates a higher stock price no *real* value is being created, the idea is not a sustainable basis for running a company—or an economy. Larry Fink, the CEO of BlackRock, the world's largest institutional investor in the world, recently called on the CEOs of the S&P 500 to stop "under-investing in innovation, skilled work-forces or essential capital

expenditures." What we have is a charade of corporate health: a temporary triumph of financial engineering over common sense and honest capitalism.

Intended as a way for firms to improve financial performance amid tougher competition, shareholder value thinking has had the opposite effect. Real returns of US corporations are now only a quarter of what they were in 1965. Real economic growth has been steadily slowing over the last five decades. The life expectancy of a large firm has declined from 75 years to just 10 years. International competitiveness has been undermined. The economy as a whole has gone into a slow long-term decline, the phenomenon that economists call "secular economic stagnation." Yet, shareholder value is still the most widely accepted idea for doing business in a public corporation.

"Today shareholder value rules business," *The Economist* proclaims, even though, as it admits, shareholder value thinking has "fueled a sense that Western economies are not delivering rising prosperity to most people" and is seen as "a license for bad conduct, including skimping on investment, exorbitant pay, high leverage, silly takeovers, accounting shenanigans and a craze for share buy-backs, which are running at $600 billion a year in America."

It is shareholder value thinking that is presumed in daily financial news reporting, accepted as a go-to for any executive of a large public company, the *modus operandi*of activist hedge funds, endorsed by regulators, institutional investors, analysts and politicians and often seen as simple common sense. It is shareholder value thinking that leads to the harmful consequences that *The Economist* article itself describes and that politicians and voters are now angry about.

Institutionalized Selfishness

The *economic* problem with shareholder value theory is therefore that it simply doesn't work, even on its own narrow terms. A singular focus on maximizing shareholder value as reflected in the stock price ends up destroying real shareholder value. It leads to behaviors that are counter-productive to the health of the organization.

The *moral* problem with shareholder value theory is that it seeks to legitimize institutionalized selfishness. It encourages managers, boards of directors, shareholders and institutional investors to look after their own interests at the expense of everyone else. Should we be surprised when ugly economic, financial and moral consequences ensue, on a vast economy-wide scale?

The Economist suggests that pursuit of shareholder value should normally result in the interests of all stakeholders being aligned. But if, as *The Economist* itself admits, the whole purpose of shareholder value thinking is to "give shareholders the whip hand," should we be surprised that other stakeholders in due course generally get whipped?

Once managers, boards of directors, shareholders and investors become wholly focused on their own financial self-interest, it is natural that they start asking themselves: why should we wait till later to get our benefits? Why not extract more money for ourselves, right now? And so the economic and moral rot begins.

And once executives accept that the purpose of business is to make money for the shareholders, including themselves, it is hardly surprising that that they slide into the practices of crony capitalism—efforts to secure subsidies, special tax breaks, import tariffs, restrictions on exports,

mandates, anti-competitive regulations, and bailouts, as documented by CEO Charles Koch in his book,*Good Profits* (2015) and the Cato Institute.

One reason why we don't hear much about all this from macro-economists is that complacent acceptance of self-interested thinking has a long history in economics. Although shareholder value theory took its current shape in the 1970s and 1980s, its intellectual roots go back to Adam Smith's *The Wealth of Nations* (1776), which spoke of "an invisible hand" that could miraculously turn selfishness from a vice into a virtue. A businessman might be intending his own gain, but in doing so, he was "led by an invisible hand to promote an end which was no part of his intention.…. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it." Shareholder value thinking thus takes the pre-existing metaphor of "an invisible hand" and proposes a license for enterprises to pursue unbridled self-interest across an entire society.

An Alternative Goal

Not all of Big Business has fallen for it.

Jack Welch, the former CEO of GE, has called shareholder value thinking "the dumbest idea in the world."

Vinci Group Chairman and CEO Xavier Huillard has called it "totally idiotic."

Alibaba CEO Jack Ma has said that "customers are number one; employees are number two and shareholders are number three."

Paul Polman, CEO of Unilever has denounced "the cult of shareholder value."

John Mackey at Whole Foods has condemned businesses that "view their purpose as profit maximization and treat all participants in the system as means to that end."

Marc Benioff, CEO of Salesforce, declared in the Huffington Post that this still-pervasive business theory is "wrong."

These representatives from Big Business are in good company. The most famous management writer of all time—Peter Drucker—pointed out that in 1954 that the only valid purpose of an enterprise is *to create a customer*. Firms that have adopted this different goal and these different management practices needed to make it happen have become radically more productive and are steadily putting firms focused on their own self-interest out of business.

Delighting customers is not only simple, clear and measurable: It is also the sure path to generating real long-term shareholder value. Shortcuts to prosperity by focusing on extracting value to shareholders or making money out of money are dangerous illusions. Prosperity comes from focusing on generating real goods and services for real human beings.

It is time for Big Business to recognize that shareholder value is the wrong way to run their companies. It may be "the biggest idea in business." But it is also both economically and morally wrong. If it continues to be pursued by as the guiding star of Big Business, the fabric of America will indeed be at risk. Peter Drucker was right. The only valid purpose of a firm is create a customer.