



The Expansion of Corporate Responsibility

Many corporations have widened their commitment to the social good. This is to be welcomed, but expectations require tempering with an awareness of what the corporate capacity for change actually is.

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For decades there has been a general consensus among economists, investors and executives in the United States and the broader Anglo-American world that corporations should operate primarily for the benefit of their “owners,” meaning their shareholders. That consensus, however, is now eroding. Serial financial crises,

corruption scandals, the perception that the system is rigged in favor of the rich and powerful, ecological problems, and concerns about a worsening distribution of wealth have led people to reexamine the role of the corporation in society. Increasingly, advocates of reform argue that businesses should be concerned about their “stakeholders”—not just shareholders but also workers, suppliers, customers, and society at large. The new movement, which is often termed “ESG” (Environmental, Social and Governance issues), is not limited to progressives and liberals, but has made substantial inroads in the commercial and financial community as well. After decades of espousing shareholder capitalism, for instance, in 2019 the Business Roundtable declared a “fundamental commitment to *all* of our stakeholders” in order to “better reflect the way corporations can and should operate today.”

Perhaps inevitably given the speed with which stakeholder-oriented capitalism has gained popularity and influence, expectations for what it can achieve have run far ahead of reality. There are serious limits to what investors and businesses can do through corporate reform to improve social and environmental outcomes: put simply, most of the heavy lifting must ultimately be done by governments. This does not mean, however, that the reformist movement is pointless. To the contrary, many companies can make a significant difference for their workers and communities without jeopardizing business success, and the corporate sector is uniquely able to focus public and political attention on what must be done within any country’s borders. Furthermore, cooperative efforts organized across the United States, Europe, and Japan could strengthen the standards governing everything from labor and the environment to accounting, transparency, and even treaties. At a time when China and other developing economies are challenging the norms of global economic governance, an international partnership between progressive companies, fund managers, and political authorities would help restore some of the prestige and soft power that the West has forfeited in recent decades.

The Pendulum Swings

For centuries the role that corporations were expected to play in society has moved between two poles: the public interest on the one hand, and the private interests of investors on the other. The earliest corporations were active partners in governmental activities. Such entities as the Dutch East India Company were granted charters on the explicit expectation that they would serve enumerated public

purposes, including in some instances serving as de facto rulers over distant colonies. This expectation changed with the passage of time. By the mid-19th century there was a trend toward “free incorporation,” a system that allowed corporations to engage in any lawful activity for purely private ends.

The balance then tipped back in the social direction after the world wars, events that required much greater mobilization of private resources and closer coordination between big businesses and government, not only in the United States but throughout the developed world. What emerged in the post-1945 era was therefore a mixed regime. Political leaders, regulators, and companies remained mutually supportive and shared a commitment to social stability and a rising standard of living for workers, both in recognition of the sacrifices those citizens had made during the conflagration and in order to prevent the rise of communism in Western Europe, Japan, and other countries. Within that generally accepted framework, however, and varying somewhat from culture to culture, firms were free to pursue the generation of profits for their investors as they saw fit.

That movement of the pendulum toward *laissez faire* economics accelerated, particularly in the United States, as memories of the wars and the Depression faded. People began to question whether the welfare state was worth the costs and inefficiencies it seemed to entail. Prominent among the skeptics were those who comprised the pro-market Chicago school of economics, which by the 1970s was gaining prestige and persuading many economists, investors, and managers that companies existed solely for the benefit of their equity owners.

Milton Friedman unintentionally became the patron saint of the emerging doctrine of shareholder primacy. In a seminal 1970 [article](#) he wrote that “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.” The advocates of profit maximization tended to focus on the first half of that passage and to ignore the latter half about the “rules of the game,” which are determined through established political processes and regulation. While Friedman was assuredly a free-market conservative, he was always cognizant of the need to protect the interests of workers and society and was accordingly never as extreme as many who marched

under his banner.

Friedman was the first thinker, for example, to propose a Universal Basic Income (UBI) in order to guarantee that all citizens enjoy a reasonable standard of living while also reducing the enormous administrative burdens of unemployment, state-run healthcare, and other needs-based welfare schemes. Friedman likewise stated that in the event of a severe economic downturn, the government should distribute free capital to all citizens—if necessary, by dropping that money from helicopters—in order to stimulate demand and recovery. Conservatives ridiculed this notion of “helicopter money” until the implosion of the subprime bubble in 2007–09 necessitated quantitative easing (QE), a form of government grants that Friedman would have resisted due to its clear bias in favor of the rich. Yet even that reconciliation was tentative and begrudging; to this day conservatives still overlook their hero’s promotion of UBI and other “liberal” ideas that they prefer to dismiss as the aspirations of deranged socialists.

Ultimately, the prophets of shareholder capitalism were closer to another leading thinker than to the logically consistent but ideologically complex Friedman. In 1971 Lewis Powell, whom Richard Nixon would soon nominate to the Supreme Court, penned his eponymous Powell Memorandum, in which he declared that the “free enterprise system” was under fire from “the Communists, New Leftists, and other revolutionaries [determined] to destroy the entire system, both political and economic.” From that febrile diagnosis, Powell proceeded to prescribe a long-term effort to curtail corporations’ social responsibilities, weaken the welfare system, and undermine liberalism in general. His action plan was for conservatives to raise large sums of money to use in promoting right-wing speakers and media, rewriting high school and college textbooks, ensconcing conservative scholars in academia and business schools, helping *laissez faire* politicians win elections at the state and national level, and using the courts to change the legal system.

The Powell Memorandum was timely and influential. Its emphasis on shareholder primacy appealed to wealthy investors and conservative intellectuals and inspired a multifaceted approach that would soon attain considerable success. The effort gained momentum with the hostile takeover battles in the 1980s and accelerated dramatically with the rise of stock-based executive compensation. These ideas became the new capitalist religion, enshrined for example in a policy statement issued by the Business

Roundtable in 1997 that “the paramount duty of management and of boards of directors is to the corporations’ stockholders; the interests of other stakeholders are relevant as derivative of the duty to stockholders.” This doctrine of shareholder primacy would eventually grow so deeply entrenched in the United States that by the late 20th century many (mistakenly) believed a new form of legal entity—the “benefit corporation,” combining the profit motive with pursuit of a publicly stated “social benefit”—was necessary to shield executives from legal action if they chose to pursue goals that did not uniformly maximize financial returns for shareholders.

This background renders the more recent swing back toward the socially conscious pole especially striking. In his 2018 annual letter to investors, Larry Fink, the influential CEO of BlackRock and one of the leading proponents of more socially responsible corporate governance, noting approvingly that “[s]ociety is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society.” Meanwhile a “stewardship” movement with non-binding codes of conduct arose in the United Kingdom to curb short-term corporate thinking. It then spread to the other Western economies, encouraging institutional investors to engage with investee companies to promote long-term sustainable growth. These same institutional investors now increasingly focus on ESG priorities in their investments. Yet even more remarkable is the extent to which corporations profess to share the new enthusiasm for stakeholder-oriented capitalism, as reflected in the 2019 Business Roundtable statement noted above. Sentiments that were once anathema to big business and major investors have thus become the new gospel.

What has impelled this ostensible change in investor and corporate sentiment? Some of the motivations are evidently self-serving: deflecting attention from the malfeasance that contributed to the 2007–09 Great Recession and more recent corporate scandals, for example, or “virtue signaling” as a form of public relations and brand management. ESG activism also performs a prophylactic function. Investors and managers realize that the United States and other OECD economies are malfunctioning badly in social and communal terms—witness global warming and other urgent ecological problems, the piecemeal public response to the coronavirus crisis, the worsening distribution of wealth and income, and the racial tensions presently roiling the world—and that enraged electorates may react by demanding the imposition of onerous new legal and regulatory burdens on businesses. To adduce a

IMPOSITION OF ONEROUS NEW LEGAL AND REGULATORY BURDENS ON BUSINESSES. TO adduce a few concrete cases, McKinsey's partnership recently rebelled against the firm's engagement with South Africa's security forces; Facebook's employees have launched campaigns against the social media company's tolerance of false and misleading political advertisements; and Google faces internal rebellion over its censorship of information in deference to Chinese sensitivities and its investments in surveillance technologies. Businesses are rightfully concerned about this widespread dissatisfaction and see advocacy of stakeholder capitalism as a means of attenuating the political threat that dissatisfaction represents.

Yet it would be a mistake to portray the new enthusiasm as entirely cynical, for many investors and executives are genuinely concerned about their communities and the legacy they will leave to their progeny. The partisan warfare and ensuing political paralysis that has gripped the United States, the United Kingdom and the EU in recent years has undoubtedly exacerbated these concerns and enhanced the desire for many economic actors to make a difference beyond their own boardrooms. Certain actors, furthermore, should have had a long-term orientation all along. Pension funds, insurance companies, and other institutional investors have obligations to their beneficiaries that must be paid out over decades and hence require robust economic growth not over the next quarter or two but for ten, twenty, or even thirty years. Exercising a broader "stewardship" that emphasizes a healthy environment, the well-being of communities, and a decent living standard for workers is the only way to guarantee the social stability and strong household consumption that drives GDP and elevates market values over that longer time horizon. So there are a number of compelling reasons for corporations to expand their vision to include more social desiderata.

Managing Expectations

Although hopes are high for what corporations and institutional investors can achieve through greater emphasis on stakeholder needs as opposed to narrower shareholder benefit, few of the ESG reformists have bothered to define what the movement's precise goals should be. This matters because in the absence of a concrete agenda people tend to assume more than is possible, and the inexorable failure to meet those expectations generates dissatisfaction and the possibility of political backlash. A brief review of the problems confronting the world today indicates that the most daunting challenges stretch far beyond the ambit of corporate power.

When the Western world emerged from World War II, governments came under intense pressure to protect workers' interests both because of the great sacrifices they had made in that conflagration and to establish a bulwark against communist agitation of the sort that would in 1947 and 1948 trouble France and Italy. In Europe, the new social contract relied heavily on the state, which would provide healthcare; generous welfare benefits; strong labor guarantees; pensions; and, through fiscal policy, a relatively equitable distribution of income and wealth. In Japan the social compact was a mixed one in which large corporations offered lifetime employment to their workers and the government offered a comprehensive program of national healthcare as well as moderate benefits to those not employed by big business. Meanwhile, American distrust of central government rendered it impossible to enact within the United States anything close to the egalitarian policies that Washington imposed on Japan, Taiwan, South Korea, and Germany in the late 1940s and 1950s. Instead, the U.S. government asked corporations to bear much of the social burden through the provision of healthcare and pensions. But these benefits only existed in large firms; the bulk of the workforce did not enjoy such protections and was left relatively exposed to the danger of job losses or major illnesses.

But strong economic growth covers a multitude of sins. In the heady years of the 1950s and 1960s, when demand for U.S. output was stimulated by postwar reconstruction in Europe and Asia and by robust domestic household consumption, even small and medium-sized companies fared well and not too many people fell through the cracks. That all-important demand began to falter, though, as other countries regained their footing and could meet their own infrastructure needs; and then especially with the onset of the two oil crises, which suppressed commerce globally. These adverse developments might well have triggered a sustained deceleration in GDP growth and social stability, but the late 1970s and 1980s brought vast financial deregulation and a consequent expansion in the ability of governments, corporations, and households to borrow to sustain their spending habits. Thus debt-fueled consumption—particularly in the United States—replaced postwar investment as the foremost engine of global GDP growth and kept employment buoyant and pensions intact, the prices of homes and other assets rising, and citizens quiescent. China's entry into the global economy would gradually become a secondary source of aggregate demand.

The reckoning came in the 21st century. The implosion of the technology bubble in

the early 2000s did considerable damage to household finances and undermined both confidence in Western capitalism and America's international prestige. Far more devastating was the 2007–09 financial debacle and the ensuing Great Recession, which revealed gaping holes in the American social safety net as well as the threadbare nature of some of the European welfare systems, and thereby precipitated a surge in popular discontent that roiled politics on both sides of the Atlantic. Chinese leaders noticed these troubles and slowed the implementation of market-opening initiatives they had pledged upon accession to the World Trade Organization and in negotiations with treaty partners, rather than risk exposure to the volatility that increasingly characterized the big Western countries. In the meantime, populist rage in North America and Europe would continue to mount through the latter half of the 2010s and probably will into the 2020s as well. This anger focused primarily on governmental and socioeconomic elites but it also included corporations and even capitalism in general. As mentioned above, the possibility that the darkening mood might lead to greater regulation of industry and finance was one of the factors that motivated the recent reconsideration of the appropriate balance between shareholder and stakeholder interests.

Yet most of these problems extend far beyond the corporate sector's remedial powers. For the underlying conundrum is not a corporate and industrial one, but rather major flaws in various post-World War II social contracts that are no longer realistic in today's circumstances. More specifically, the aging of the richest cohorts in the developed world, the severity of the Great Recession, and the intensification of that downturn through the coronavirus crisis have lowered the long-term growth rates of the global and OECD economies. Slower growth in turn means less national income to tax and redistribute; weaker demand for labor and more unemployment; and, through lower inflation, suppressed interest rates and stimulative monetary policy, massive expansions in liquidity that inexorably lead to market appreciation, and a bigger transfer of national wealth to those fortunate enough to own assets.

Requiring investors and corporate executives to pay more attention to the effects of their conduct on workers, communities, social justice, and the environment is doubtless a good idea. But asking them to reverse demographic trends, redress fiscal and monetary imbalances, improve the distribution of income and wealth, and change regulatory regimes to ameliorate social and political biases in favor of the rich and powerful is patently unreasonable.

The gulf between the challenges confronting the OECD economies on the one hand and the capacity of businesses to solve them on the other is evident in even a cursory examination of two critical sets of actors: large corporations and the institutional investors that collectively own much of their equity. Publicly listed corporations—the ones that would be directly involved in the new stakeholder capitalism and its various behavioral codes—account for less than 1 percent of all U.S. firms and only a third of total non-farm employment. So even aggressive reforms in big corporations' employment practices and worker benefits would never reach the vast majority of American workers or ramify through the small- and medium-sized firms that comprise the greater part of the economy.

Moreover, no matter how supportive these big companies were to become, their efforts would never amount to a national healthcare or pension system or engender a significant improvement in the distribution of wealth and income. Similarly, individual firms could assuredly reduce their ecologically destructive behaviors and perhaps adopt reparatory measures, but those will never amount to a coherent program to address climate change. In the bigger picture, therefore, corporations are secondary actors.

It is also important to note that many companies in the United States and the OECD do not embrace comprehensive ESG reform. Preference for the status quo stems in part from the nature of the corporation itself, an entity that is run by senior executives appointed and overseen by a board of directors elected by a single stakeholder—the shareholders. In the words of Leo Strine, Jr., the recently retired Chief Justice of the Delaware Supreme Court, which serves as the main arbiter of corporate governance standards in the United States, “Corporate power is corporate purpose.” So no matter how socially conscious a firm's managers may be, they cannot be expected to pursue business strategies that threaten the financial interests of their shareholders. Given the lack of diversity in the boardrooms of corporate America, furthermore, it is not obvious that urging directors to make public policy is a sound strategy.

Effecting ESG reform would obviously be easier if the institutional investors who dominate ownership of publicly traded firms were uniformly committed to the cause, but here too there are structural, volitional, and technical obstacles. Structurally, many institutional investors are not staffed to monitor full portfolios of companies to ensure they meet ESG criteria. More problematic still, over the last 15 years the industry has

they meet ESG criteria. More problematic still, over the last 10 years the industry has moved away from active fund management in favor of index investing, whereby a fund manager holds a portfolio that mimics a particular benchmark like the S&P 500 and is automatically adjusted to reflect changes in that underlying benchmark. This switch to low-cost, passive investment strategies has been a boon to retirement accounts but it has led to a concentration of corporate ownership in the hands of three massive institutional investors—Vanguard, BlackRock and State Street—which now collectively comprise the largest ownership block in 40 percent of all listed U.S. companies and almost 90 percent of S&P 500 companies.

With their core strategies thus focused on investments that are constantly undergoing algorithmic rebalancing, and with limited incentives to outperform the relevant benchmark, the Big Three and other institutional investors cannot realistically devote the resources necessary to monitor and affect the ESG performance of their portfolio companies. If the Big Three were to coordinate their efforts they might be able to advance stakeholder capitalism to some degree, but concretizing that determination would be difficult and could exacerbate antitrust concerns about “parallel ownership” by a few huge institutional investors.

A related structural barrier arises from the price efficiency of financial markets. Although “impact” investors in private equity and venture capital can to some extent subsidize businesses with admirable social performances and penalize the more recalcitrant, it is virtually impossible for investors in publicly traded securities to do so. In the vast majority of cases, ESG-motivated stock trades simply create arbitrage opportunities for “socially neutral” investors who only care about financial returns. If progressive investors divested from companies in a polluting industry, for example, or from producers of tobacco products, the decline in share prices would merely invite investors focused solely on financial returns to buy the shares more cheaply. Those purchases, in turn, would return the share prices to the *ex ante* equilibrium level and the target companies would continue to operate as before. In the case of publicly traded firms, therefore, barring a fundamental shift in consumer preferences or an economy-wide campaign against a particular industry or business practice, the efficiency of capital markets blunts the effect of ESG investing.

Finally, the pro-social stance assumed by the Business Roundtable is not universally shared by institutional investors. The organization’s 2019 declaration in favor of stakeholder capitalism quoted above almost instantaneously brought forth an acid

rejoinder by the Council of Institutional Investors, which remarked that “accountability to everyone means accountability to no one.” This reaction harks back to the truncated Friedman dictum that corporations exist solely to generate profits for their shareholders.

The bottom line is that with regard to distributional patterns, the social safety net, and environmental concerns, the corporate sector is perforce a secondary actor. The bulk of the work must be done by governments. Only governments can decide fiscal and monetary policies; extend better protection to all their workers and citizens; negotiate trade agreements; consent to international legal regimes; create and finance multilateral organizations; and organize cooperative endeavors to address pandemics, climate issues, and other global issues. Corporations can make substantial contributions by improving their own conduct and leading by example, and institutional investors can help by adopting a long-term perspective and encouraging managers to consider objectives other than financial returns—assuming that workable non-financial performance metrics can be agreed upon. But one must remember the practical constraints that bind both institutional investors and corporate executives. Ultimately what matters most is the will of democratic nations as manifested in their choice of political leaders.

What Corporations Can Do

The purpose of the foregoing analysis is not to discourage corporate reform but rather to render expectations of what it can accomplish more realistically and to channel the present enthusiasm more effectively. There truly is no alternative to forceful remedial and forward-looking action by the governments of Europe, Japan, and particularly the United States. Within that context, however, business enterprises can play a vital role. If taken seriously and made compatible with the incentives of institutional investors and corporate executives, ESG-oriented reforms can reduce the damage that many self-interested firms presently do within their own metaphorical neighborhoods. Moreover, by publicizing these initiatives companies, investors, and their executives can focus public attention on pressing social problems and hence compel national politicians and international organizations like the World Bank and the regional development banks to clarify the respective roles and obligations of the private sector and the state. By thus openly moving in a more responsible direction, firms and their investors can encourage politicians to address systemic shortcomings well beyond the corporate remit

well beyond the corporate realm.

At least as important is the service that enlightened corporations can provide in affecting the evolution of global commercial norms. After the end of World War II, the United States and its Japanese and European allies dominated the formation of international governance structures like the big multilateral organizations, trade agreements, accounting and disclosure requirements, the rules of fair competition, and industrial standards. These institutions protected Western interests and values, gave American and European firms a marginal advantage in international markets, and predisposed emerging economies to adopt the political and economic priorities of the leading democracies. Although not as sexy as large military arsenals, this “soft power” and the ability it conferred to define international norms of behavior were immensely valuable.

That the rise of non-Western economies such as China, India, and others would erode some of that soft power advantage was always clear. It was predictable, for instance, that the entrance into the global labor force of hundreds of millions of Chinese would depress wages globally, encourage OECD companies to replace many of their workers with cheaper foreigners, and undermine the ability of developed-world employees to organize unions and otherwise protect their wages and benefits. But the phenomenon was more comprehensive than that, with China negotiating trade agreements with its neighbors that did not respect the established Western principles for transparency and disclosure, workers’ rights, anti-corruption measures, and the environment.

Then came the wave of populism that swept over the rich world in recent years and led a number of OECD governments to surrender their ability to influence international standards of conduct. Salient in this regard were the Trump administration’s precipitous withdrawal from the Trans-Pacific Partnership, its violation of longstanding U.S. interests by interrupting trade relations not just with China but even with its North American neighbors and its allies in Europe, its insouciance toward NATO and other alliances, and its support for the United Kingdom’s departure from the European Union. More recently, both the United States and the United Kingdom largely stood by as Beijing contravened its own treaty commitments by asserting heavy-handed control over Hong Kong, an erstwhile bastion of Western financial and legal institutions in East Asia. Along with the

coronavirus crisis, these episodes of Western misteasance sharply enhanced China's power around the world and thereby empowered it to redefine commercial norms more substantially than would otherwise have been possible.

Here socially conscious institutional investors and reformist corporations can have an additional positive effect. Since U.S., Japanese, and European investment groups and corporations remain for the moment disproportionately powerful, a united front among them could slow the erosion of the standards according to which international business is conducted. Such concerted efforts would also help resolve the “one company, two systems” dilemma—the increasingly untenable strategy of U.S. tech companies to maximize shareholder profits by lowering their standards in China (and now Hong Kong) while still claiming adherence to values such as freedom of expression and the protection of human rights. In effect, the corporate sector would provide the foresight and leadership that politicians in the West presently lack until the paralysis that has stymied governmental action on major social and economic issues is overcome through the electoral process. Such concerted corporate action would restore normative legitimacy to American capitalism, a vital aspect of the social contract that has been damaged by the excesses of shareholder supremacy. For without that consensus at home, there is little chance that the United States can reassert its influence around the world.

Fads come and go in the business world, particularly when companies seek shelter from social and political storms they hope will soon blow over. The instinct for self-preservation undoubtedly plays a role in the recent corporate embrace of stakeholder capitalism. There is a serious risk that the enthusiasm for more socially responsible corporate governance will dissipate when the limits of investor and corporate power to fix social problems become clear.

Yet the stakeholder-oriented governance movement remains vital. Not only can advocacy of ESG reforms make firms more responsible actors in their own communities, it can also intensify pressure on governments to reconstruct the foundations of political and economic stability and reinforce beneficial commercial norms in a world that sorely needs them. A partnership among institutional investors, corporations, and ultimately Western governments could additionally facilitate the effort to reclaim the high ground in the struggle with China for soft power. The key is therefore to manage popular expectations for what companies can realistically achieve, identify the most promising agenda, and then move forward with

achieve, identify the most promising agenda, and then move forward with determination.

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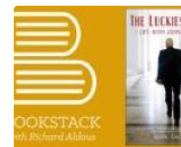
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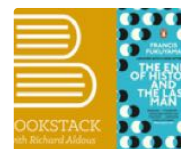
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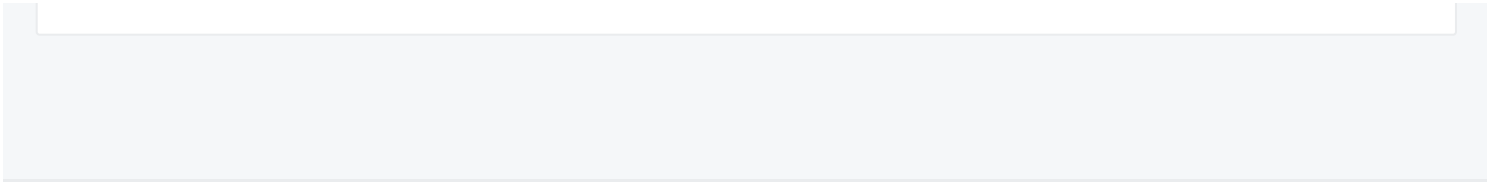
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