

Corporate Democracy

Luigi Zingales

Based on work with

Oliver Hart



A Friedman doctrine— **The Social Responsibility Of Business Is to Increase Its Profits**

By MILTON FRIEDMAN

TAKING G.M.—Chairman James Roche of General Motors (right) replies to members of Campaign G.M. (below, wearing "Tame G.M." buttons) at the corporation's stockholders' meeting in May. Representatives of the campaign demanded that G.M. name three new directors to represent "the public interest" and set up a committee to study the company's performance in such areas of public concern as safety and pollution. The stockholders defeated the proposals overwhelmingly, but management, apparently in response to the second demand, recently named five directors to a "public-policy committee." The author calls such drives for social responsibility in business "pure and unadulterated socialism," adding: "Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society."



Jerome Kretschmer, New York Environmental Protection Administrator.



Betty Fereis, consumer-advocate in the Johnson Administration.



Philip Swensen, chairman of Campaign G.M.'s parent organization.



John Episcopo, lawyer and coordinator of Campaign G.M.

- “In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business.
- He has direct responsibility to his employers.
- That responsibility is to conduct the business in accordance with their desires,
- which generally will be to make as much money as possible
- while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom.”

The theory of economic regulation

George J. Stigler

The University of Chicago

The potential uses of public resources and powers to improve the economic status of economic groups (such as industries and occupations) are analyzed to provide a scheme of the demand for regulation. The characteristics of the political process which allow relatively small groups to obtain such regulation is then sketched to provide elements of a theory of supply of regulation. A variety of empirical evidence and illustration is also presented.

■ The state—the machinery and power of the state—is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries. That political juggernaut, the petroleum industry, is an immense consumer of political benefits, and simultaneously the underwriters of marine insurance have their more modest repast. The central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources.

Regulation may be actively sought by an industry, or it may be thrust upon it. A central thesis of this paper is that, as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit. There are regulations whose net effects upon the regulated industry are undeniably onerous; a simple example is the differentially heavy taxation of the industry's product (whiskey, playing cards). These onerous regulations, however, are exceptional and can be explained by the same theory that explains beneficial (we may call it "acquired") regulation.

Two main alternative views of the regulation of industry are

Short Circuit

Friedman: Maximize profits given the rules

+

Stigler: Powerful incumbents change the rules to maximize profits

= If powerful: maximize profits with no rules

- The idea that in powerful firms unrestrained profit maximization can be tamed by regulation is inconsistent with
 - Stigler
 - Evidence

Does a CEO have a duty to lobby?

1. Privately managed prisons.

- They benefit from
 - Higher incarceration rates
 - Longer sentences
- Should they lobby to lengthen the sentences?

2. Oil companies

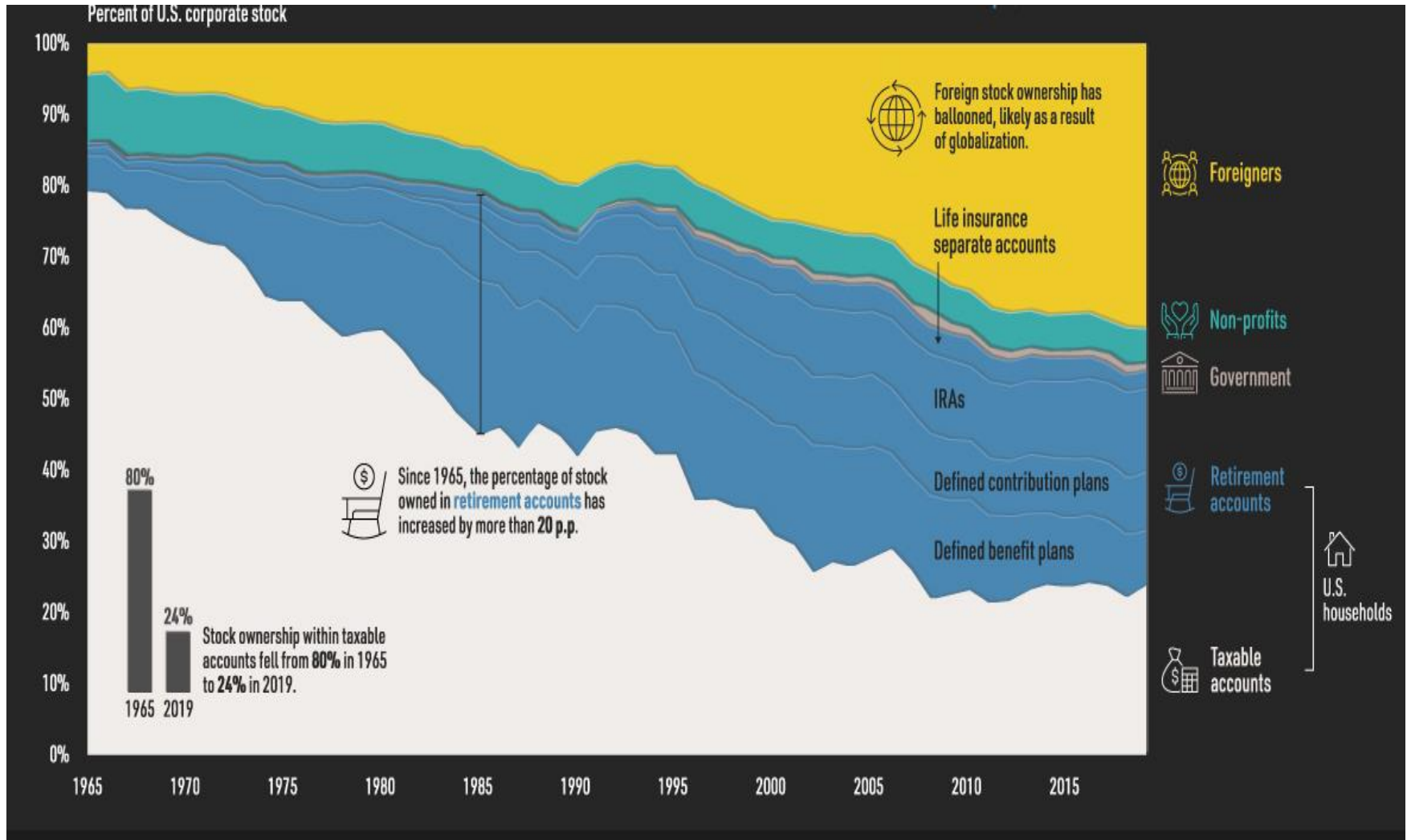
- They benefit from more fossil fuel consumption
- Should they lobby to slow down the transition to renewables?
- Do they have a fiduciary duty to finance climate deniers to create uncertainty about the science and slow down the transition to renewables?

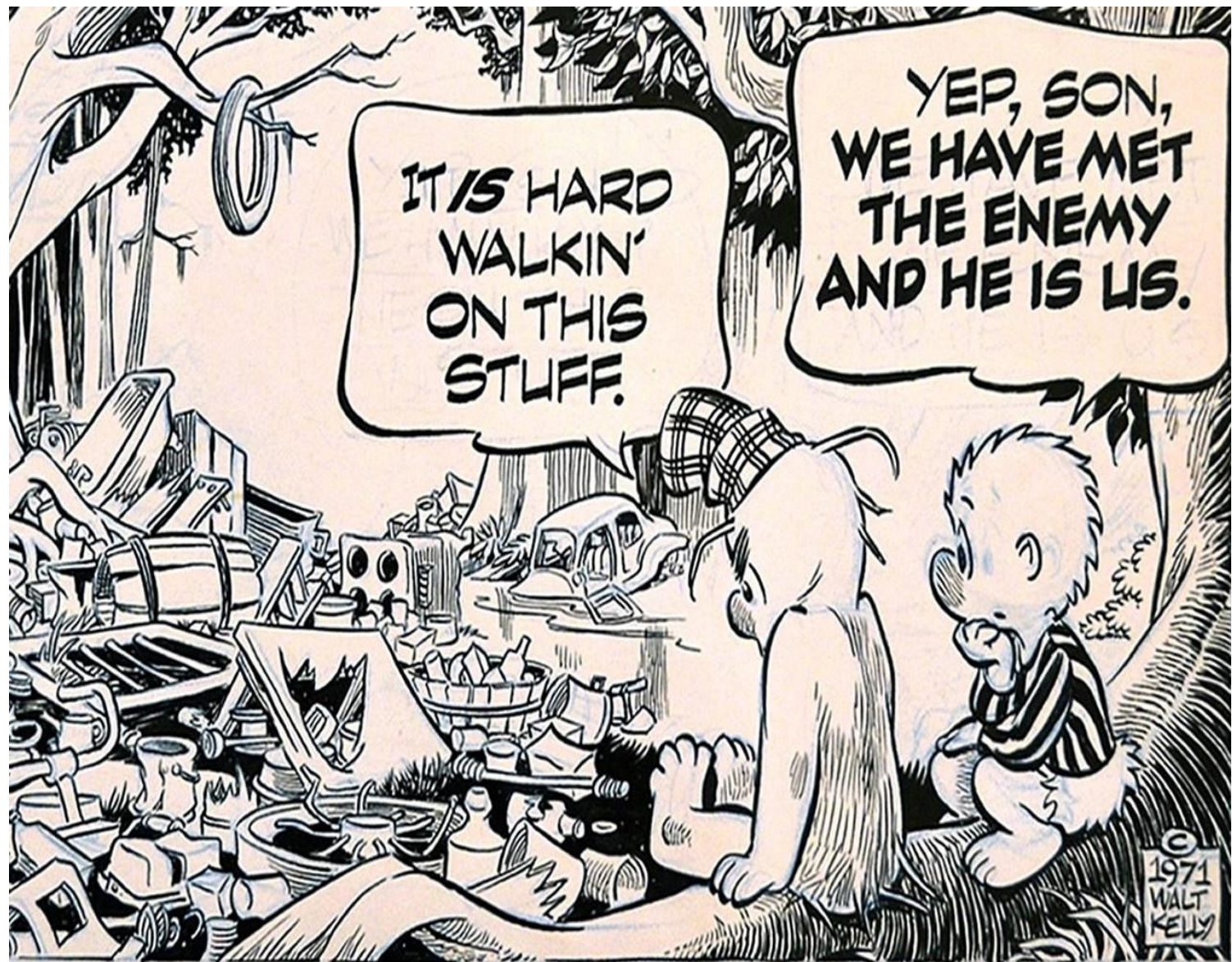
<https://vimeo.com/568865247>



"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

For Whom?





IT IS HARD
WALKIN'
ON THIS
STUFF.

YEP, SON,
WE HAVE MET
THE ENEMY
AND HE IS US.

©
1971
WALT
KELLY

<https://www.youtube.com/watch?v=5lsExRvJTAI&list=PPSV>

How can we resolve this
tension without destroying
capitalism?

1

Political Power of Firms

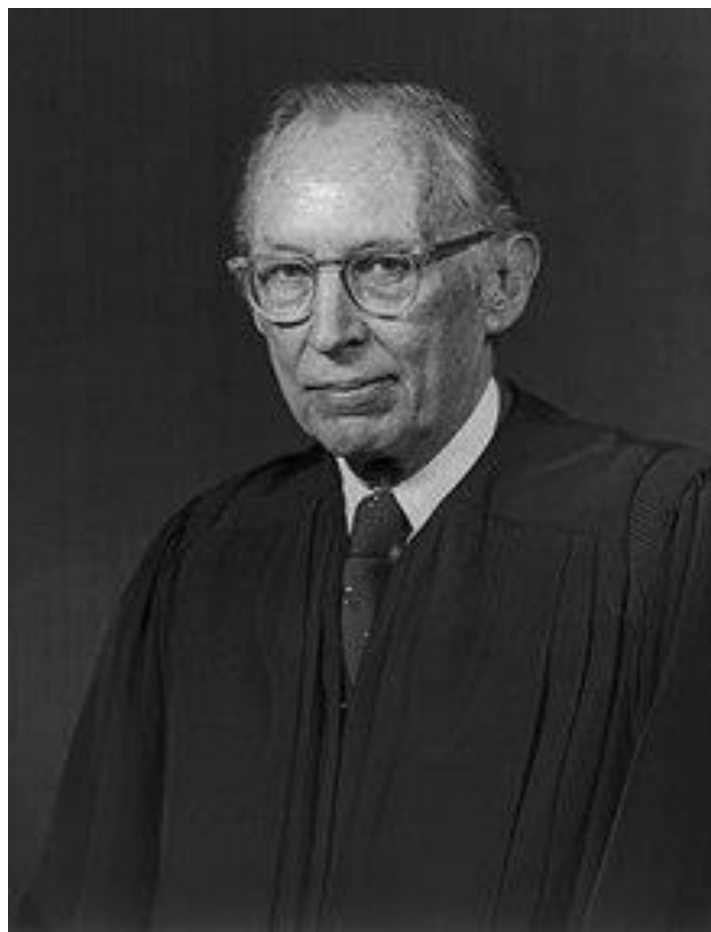
Apolitical Firms

- Friedman:
- “The businessmen believe that they are defending free enterprise when they declaim that business is not concerned "merely" with profit but also with promoting desirable "social" ends ...
- In fact, they are--or would be if they or anyone else took them seriously--preaching pure and unadulterated socialism.”
- “if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

Alternative

- “The day is long past when the chief executive officer of a major corporation discharges his responsibility by maintaining a satisfactory growth of profits, with due regard to the corporation's public and social responsibilities. If our system is to survive, top management must be equally concerned with protecting and preserving the system itself.”
- “Business must learn the lesson . . .
 - that political power is necessary;
 - that such power must be assiduously cultivated;
 - and that when necessary, it must be used aggressively and with determination—
 - without embarrassment and without the reluctance which has been so characteristic of American business.”
- Who wrote it?

Lewis Powell



Powell's memo

- In a confidential memo to the US Chamber of Commerce, future Supreme Court justice Lewis Powell describes a strategy to react to the "Attack on the American Free Enterprise System."
- As every business executive knows, few elements of American society today have as little influence in government as the American businessman, the corporation, or even the millions of corporate stockholders.
- "The time has come - indeed, it is long overdue - for the wisdom, ingenuity and resources of American business to be marshaled against those who would destroy it."

The Memo's Plan

1. Campus

“Perhaps the most fundamental problem is the imbalance of many faculties. Correcting this is indeed a long-range and difficult project. Yet, it should be undertaken as a part of an overall program. This would mean the urging of the need for faculty balance upon university administrators and boards of trustees.”

“The Chamber should enjoy a particular rapport with the increasingly influential graduate schools of business.”

2. Media

“It is especially important for the Chamber's “faculty of scholars” to publish”

“Incentives might be devised to induce more 'publishing' by independent scholars who do believe in the system.”

3. Political power

“Business must learn the lesson . . . that political power is necessary; that such power must be assiduously cultivated; and that when necessary, it must be used aggressively and with determination—without embarrassment and without the reluctance which has been so characteristic of American business.”

4. Neglected Opportunity in the Courts

“Under our constitutional system, especially with an activist-minded Supreme Court, the judiciary may be the most important instrument for social and political change”

“This is a vast area of opportunity for the Chamber, if it is willing to undertake the role of spokesman for American business and if, in turn, business is willing to provide the funds.”

5. Neglected Stockholder Power

“stockholders have been as ineffectual as business executives in promoting a genuine understanding of our system or in exercising political influence”

“But is it not feasible - through an affiliate of the Chamber or otherwise - to establish a national organization of American stockholders and give it enough muscle to be influential?”

The Political Role of Firms

- In 1969, The Medical Committee for Human Rights advanced a proposal to amend Dow's Certificate of Incorporation to “prohibit the sale of napalm unless the purchaser gives reasonable assurance that the napalm will not be used against human beings.”
- Dow responded that it intended to omit the proposal appealing to SEC regulation.
- Dow’s defense: We are not producing napalm for profit. We lose money producing it; we produce it for patriotism.

Political Actors

- Firms are political actors
- Pretending they are not, it is at best naïve at worst a machination to disguise their political role
- Kalven's report:
“In the exceptional instance, these corporate activities of the university may appear so incompatible with paramount social values as to require careful assessment of the consequences.”
- If they are political actors, in whose interest should they act?

2

Where Friedman Was Wrong

- Friedman assumes that shareholders' desire "generally will be to make as much money as possible"
- In economics, we assume that individuals maximize utility not income
- Utility includes
 - Impact firms have on our political system
 - Impact firms have on our environment
 - In addition, if investors are even slightly prosocial, impact firms have in the world at large
- Hart and Zingales (2017): companies should maximize shareholder welfare (not value)

Shareholder Welfare Maximization

- One of the advantages of SVM is its simplicity.
- If the goal is SVM, managers do not need to consult shareholders much: they know that more profits are better.
- The moment the objective is SWM, matters become more complex.
- How can we encourage shareholders to report their preferences truthfully and how should the preferences of shareholders be aggregated?
- Let's assume that shareholders are
 1. Well-informed about the cost and benefits
 2. Willing to vote on controversial issues at no cost
- Then, they can transmit their preferences to the companies they own through voting.

1. Selfish Shareholders Directly Affected

- Let's assume that by distorting regulation a company generates a profit δ at a cost for society of h .
- Then, each shareholder with a share s_i will oppose lobbying if

$$- s_i \delta + \lambda_i h > 0$$

where λ_i captures how the societal harm h affects the utility of shareholder i .

- Easy to see that shareholders will never oppose socially efficient lobbying ($\delta > h$).
- Yet they will still let inefficient lobbying go if $\sum_i \lambda_i < 1$

2. Prosocial Shareholders

- Let's assume that by paying a cost δ a company can reduce a social cost h .
- Let λ capture how prosocial a shareholder is
- Then, each shareholder with a share s will vote to avoid pollution is

$$- s_i \delta + \lambda_i [h - (1 - s_i)] > 0$$

- This can be rewritten as

$$- s_i \delta (1 - \lambda_i) + \lambda_i [h - \delta] > 0$$

- Shareholders will only vote for something that is socially efficient ($h > \delta$).
- Would they vote in favor every time that is socially efficient?

Broccardo, Hart, and Zingales (2022)

- Assume there are n shareholders
- Assume that all shareholders have equal wealth and that they diversify their portfolio among n stocks
- A shareholder would vote in favor if

$$-\frac{\delta}{n} + \lambda \left[h - \frac{n-1}{n} \delta \right]$$

- If shareholders are well diversified, $n \rightarrow \infty$, as long as $\lambda > 0$, they will vote in favor if and only if

$$h > \delta$$

i.e., when the project is efficient.

Important Result

- If well-diversified shareholders are only slightly prosocial, they will vote as the central planner would
- The intuition is very simple:
 - My vote matters only when it is pivotal
 - If my vote can change Exxon's strategy, it will have an enormous social impact
 - So a small shareholder compares a small cost with an enormous social impact
 - You do not need to be very prosocial for the enormous social impact to prevail
- If the majority is slightly prosocial, you obtain the first-best

Problem

- Almost half of the U.S. population does not vote once every four years in the presidential election.
- How can we expect shareholders to vote every year for hundreds of stocks they own through their mutual funds?
- We cannot.
- Even if we could force them, this would be tremendously inefficient
- If we want corporate democracy to work, we need an alternative solution

3

**A New Form of Corporate
Democracy**

Investors Assemblies

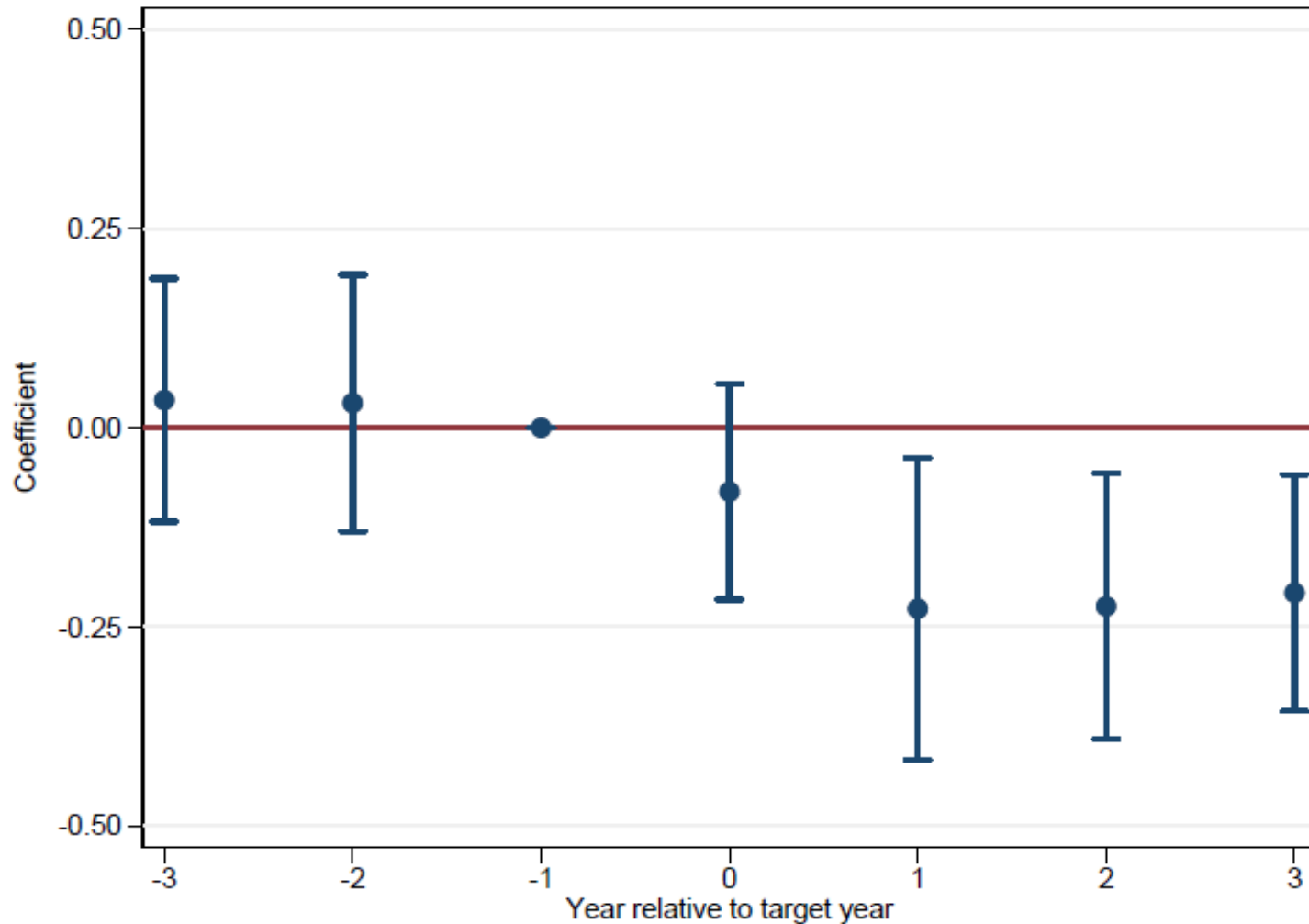
- An old idea is resurfacing in political science: randomly selected citizens' assemblies.
- A 2020 OECD report has documented up to 800 cases of government-mandated randomly selected assemblies across OECD countries since the 1990s (most of them since 2010).
- Citizens' assemblies are relatively large bodies of individuals (at least 100) chosen at random (technically through stratified random sampling) from the larger population.
- The members of such assemblies are compensated for their time and expenses and provided with resources, briefing materials, and access to experts.

- With Oliver Hart and Helen Landemore, we are working to apply this idea to large US mutual funds (like Vanguard).
- This assembly can vote on some guidelines or appoint a delegate to vote at shareholders' meetings.
- This system guarantees full representation
 - i. Minimizing the participation costs
 - ii. Reducing the lobbying advantage of the rich
- It overcomes the rational ignorance paradigm that plagues democracy.
- Cooper, van der Stoep, and Bauer (2024) have applied a similar idea in the Netherlands
- Meta has tried something similar with its users.

4

Does It Matter?

Toxic Chemical Releases Around Environmental Activism



Conclusions

- Corporations have a large impact on society beyond the economic value added they generate.
- Traditionally, these externalities have been dealt via regulation or taxation. But
 1. Regulation cannot function if large and powerful corporations use all their power to squelch it.
 2. Regulation often does not exist when Western corporations operate in developing countries
 3. As a combination of public welfare and private charity is superior to a system based only on one of the two, so a combination of shareholder democracy and regulation is superior to a system based on only one of the two.
- While corporate democracy is an improvement, it is not going to solve all the problems.
- More work needs to be done.