SHAREHOLDER VALUE AS YESTERDAY'S IDEA

Rebecca Henderson

What is capitalism?

One of humanity's greatest inventions, and the greatest source of prosperity the world has ever seen?

A menace on the verge of destroying the planet and destabilizing society?

Or some combination that needs to be reimagined?

We need a systemic way to think through these questions. The best place to start is with the three great problems of our time—problems that grow more important by the day: massive environmental degradation, economic inequality, and institutional collapse.

The world is on fire. The burning of fossil fuels—the driving force of modern industrialization—is killing hundreds of thousands of people, while simultaneously destabilizing the earth's climate, acidifying the oceans, and raising sea levels. Much of the world's topsoil is degraded, and demand for fresh water is outstripping supply. Left unchecked, climate change will substantially reduce GDP, flood the great coastal cities, and force millions of people to migrate in search of food. Insect populations are crashing and no one knows why—or what the consequences will be. We are running the risk of destroying the viability of the natural systems on which we all depend.

Wealth is rushing to the top. The fifty richest people among them own more than the poorer half of humanity, while more than six billion live on less than $16 a day. Billions of people lack access to adequate education, health care, and the chance for a decent job, while advances in robotics and artificial intelligence (AI) threaten to throw millions out of work.

The institutions that have historically held the market in balance—families, local communities, the great faith traditions, government, and even our shared sense of ourselves as a human community—are crumbling or even vilified. In many countries the increasing belief that there is no guarantee that one's children will be better off than oneself has helped to fuel violent waves of anti-minority and anti-immigrant sentiment that threaten to destabilize governments across the world. Institutions everywhere are under pressure. A new generation of authoritarian populists is taking advantage of a toxic mix of rage and alienation to consolidate power.

You may wonder what these problems have to do with capitalism. After all, hasn't the world's GDP quintupled in the last fifty years, even as population has doubled? Isn't average GDP per capita now over $10,000—enough to provide every person on the planet with food, shelter, electricity, and education? And, even if you think business should play an active role in attempting to solve these problems, doesn't it seem, at first glance, an unlikely idea? In the majority of our boardrooms and our MBA classrooms, the first mission of the firm is to maximize profits. This is regarded as self-evidently true. Many managers are persuaded that to claim any other goal is to risk not only betraying their fiduciary duty but also losing their job. They view issues such as climate change, inequality, and institutional collapse as "externalities," best left to governments and civil society. As a result, we have created a system in which many of the world's companies believe that it is their moral duty to do nothing for the public good.

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But this mind-set is changing, and changing very fast. Partly this is because millennials are insisting that the firms they work for embrace sustainability and inclusion. When I first launched the MBA course that became "Reimagining Capitalism," there were twenty-eight students in the room. Now there are nearly three hundred, a little less than a third of the Harvard Business School class. Thousands of firms have committed themselves to a purpose larger than profitability, and nearly a third of the world's financial assets are managed with some kind of sustainability criterion. Even those at the very top of the heap are beginning to insist that things have to change. In January 2018, for example, Larry Fink, the CEO of BlackRock, the world's largest financial asset manager, sent a letter to the CEOs of all the firms in his portfolio that said the following: "Society 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. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

BlackRock has just under $7 trillion in assets under management, making it among the largest shareholders in every major publicly traded firm on the planet. It owns 4.6 percent of Exxon, 4.3 percent of Apple, and close to 7.0 percent of the shares of JPMorgan Chase, the world's second-largest bank. For Fink to suggest that "companies must serve a social purpose" is the rough equivalent of Martin Luther nailing his ninety-five theses to Wittenberg Castle's church door. The week after his letter came out, a CEO friend reached out to me to confirm that surely he didn't—really—mean it? My friend was in a state of shock. He had based a long and successful career on putting his head down and maximizing shareholder value, and to him Fink's suggestion seemed ludicrous. He couldn't imagine taking his eye off the profit ball in today's ruthlessly competitive world.

In August 2019 the Business Roundtable—an organization composed of the CEOs of many of the largest and most powerful American corporations—released a statement redefining the purpose of the corporation: "To promote an economy that serves all Americans." One hundred and eighty-one CEOs committed to lead their companies for "the benefit of all stakeholders: customers, employees, suppliers, communities, and shareholders." The Council of Institutional Investors (CII)—a membership organization of asset owners or issuers that includes more than 135 public pension and other funds with more than $4 trillion in combined assets under management—was not amused, responding with a statement that said, in part:

CII believes boards and managers need to sustain a focus on long-term shareholder value. To achieve long-term shareholder value, it is critical to respect stakeholders, but also to have clear accountability to company owners. Accountability to everyone means accountability to no one. BRT has articulated its new commitment to stakeholder governance… while (1) working to diminish shareholder rights; and (2) proposing no new mechanisms to create board and management accountability to any other stakeholder group.

One of the world's largest financial managers insists that "the world needs your leadership," and some of the world's most powerful CEOs publicly commit to "stakeholder management," while many businesspeople—like my (hugely successful) CEO friend and many large investors—think they are asking for the impossible. Which of them is right? Can business really—and I mean really—rescue a world on fire?

I've spent the last fifteen years of my life working with firms that are trying to solve our environmental and social problems at scale—largely as a means of ensuring their own survival—and I've come to believe that business has not only the power and the duty to play a huge role in transforming the world but also strong economic incentives to do so. The world is changing. The firms that change with it will reap rich returns—and if we don't reimagine capitalism, we will all be significantly poorer.

I started this journey with an appropriately British degree of skepticism, but I am now surprisingly optimistic—in the "if we work really hard, we might just succeed" sense of optimistic. We have the technology and the resources to build a just and sustainable world, and doing so is squarely in the private sector's interest. It is going to be hard to make money if the major coastal cities are underwater, half the population is underemployed or working at jobs that pay less than a living wage, and democratic government has been replaced by populist oligarchs who run the world for their own benefit. Moreover, embracing a pro-social purpose beyond profit maximization and taking responsibility for the health of the natural and social systems on which we all rely not only makes good business sense but is also morally required by the same commitments to freedom and prosperity that drove our original embrace of shareholder value.

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A mere decade ago the idea that business could help save the world seemed completely crazy. Now it's not only plausible but also absolutely necessary. I'm not talking about some distant utopia. It's possible to see the elements of a reimagined capitalism right now, and to see how these elements could add up to profound change—change that would not only preserve capitalism but also make the entire world better off. Indeed this book is an attempt to persuade you to give your life to the attempt.

HOW WE GOT HERE

A central cause of the problems we face is the deeply held belief that a firm's only duty is to maximize "shareholder value." Milton Friedman, perhaps the most influential intellectual force in popularizing this idea, once stated that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits." From here it's not far to the idea that focusing on the long term or the public good is not only immoral and possibly illegal but also (and most critically) decidedly infeasible. It is true that the capital and product markets are ruthless places. But in its current incarnation, our focus on shareholder value maximization is an exceedingly dangerous idea, not just to the society and the planet, but also to the health of business itself. Turing Pharmaceuticals' experience with Daraprim illustrates the costs of chasing profits at the expense of everything else.

In September 2015, Turing, a small start-up with only two products, announced that it was raising the price of the generic drug Daraprim from $13.50 to $750 a tablet—an approximately 5,000 percent increase. Daraprim was widely used to treat complications from AIDS. It cost approximately $1 per pill to produce and had no competition. Anyone wanting to buy Daraprim had to buy it from Turing. The move unleashed a media storm.

Martin Shkreli, Turing's CEO, was vilified in the press and accosted in public. But he was unrepentant. Asked if he would do anything differently, he replied:

I probably would have raised prices higher.... I could have raised it higher and made more profits for our shareholders. Which is my primary duty.... No one wants to say it, no one's proud of it, but this is a capitalist society, capitalist system and capitalist rules, and my investors expect me to maximize profits, not to minimize them, or go half, or go 70 percent, but to go to 100 percent of the profit curve that we're all taught in MBA class.

It's tempting to believe that Shkreli is an outlier. He is a deeply eccentric person and currently in jail for defrauding his investors. But he expressed in the starkest terms the implications of the imperative to make as much money as you can, and Daraprim is not the only generic drug to have had its price hiked. In 2014, Lannett, another generic pharmaceutical producer, raised the price of Fluphenazine—a drug that is used to treat schizophrenia and is on the World Health Organization's list of most essential medicines—from $43.50 to $870—a 2,000 percent increase. Valeant increased the prices of Nitropress and Isuprel—two leading heart drugs—by more than 500 percent, reportedly leaving the firm with gross margins of more than 99 percent.

Surely this can't be right. Do managers really have a moral duty to exploit desperately sick people? Purdue Pharma's decision to aggressively promote the prescribing of OxyContin was—at least in the short term—hugely profitable. Does this mean that it was right or even good business? Do firms have a duty to pursue the maximum possible profit, even when they know that doing so will almost certainly have significantly negative consequences for their customers, their employees, or society at large?

Since December 2015, when the Paris Climate Agreement was signed, for example, the world's fossil fuel companies have spent more than a billion dollars lobbying against controls on greenhouse gas (GHG) emissions. Lobbying in favor of heating up the planet may have maximized shareholder value in the short term, but in the long run, was it a good idea?

Taken literally, a single-minded focus on profit maximization would seem to require that firms not only jack up drug prices but also fish out the oceans, destabilize the climate, fight against anything that might raise labor costs–including public funding of education and health care, and (my personal favorite) attempt to rig the political process in their own favor. In the words of one political cartoon: "Yes, the planet got destroyed, but for a beautiful moment in time we created a lot of value for shareholders."

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Business was not always wired this way. Our obsession with shareholder value is relatively recent. Edwin Gay, the first dean of the Harvard Business School, suggested that the school's purpose was to educate leaders who would "make a decent profit, decently," and as late as 1981, the Business Roundtable issued a statement that said, in part: "Business and society have a symbiotic relationship: The long-term viability of the corporation depends upon its responsibility to the society of which it is a part. And the well-being of society depends upon profitable and responsible business enterprises."

WHY MARKETS ARE FAILING US

The Turing Pharmaceutical example illustrates the essential nature of the problem—but we can be even more precise. Markets have gone off the rails for three reasons: externalities are not properly priced, many people no longer have the skills necessary to give them genuine freedom of opportunity, and firms are increasingly able to fix the rules of the game in their own favor.

Energy is cheap because we don't pay its full costs. American consumers pay roughly five cents per kilowatt-hour (¢/kWh) for electricity from coal-fired power plants. But burning coal emits enormous quantities of CO2 (coal is essentially fossilized carbon)—one of the leading causes of global warming. Producing a kilowatt-hour of coal-fired electricity causes at least another four cents of climate-related damage. Moreover, burning coal kills thousands of people every year and destroys the health of many more. The extraction, transportation, processing, and combustion of coal in the United States cause twenty-four thousand lives to be lost every year due to lung and heart disease (at a cost of perhaps $187.5 billion per year); eleven thousand additional lives are lost annually due to the high health burdens found in coal-mining regions (an annual cost of perhaps $74.6 billion). Calculating an aggregate, global figure for the health costs associated with burning fossil fuels is enormously difficult since costs differ significantly depending on a wide range of factors, including the type of fuel and on how and where it's being burned. One estimate suggests that every ton of CO2 emissions is associated with current health care costs of about $40, which would imply a cost per kWh of about four cents, but my colleagues who work in this area remind me that these costs can vary enormously and are often much higher. When you add these costs back in, the real cost of a kilowatt-hour of coal-fired electricity is thus not 5¢ but something more like 13¢. This means we are only paying about 40 percent of the real costs of burning coal. Fossil fuel energy looks cheap—but only because we're not counting the costs we are imposing on our neighbors and on the future.

Every coal-fired plant on the planet is actively destroying value, in the sense that the costs these plants are imposing on society are greater than their total revenues, let alone their profits. For example, Peabody Energy, the largest coal company in the United States, shipped 186.7 million tons of coal in 2018 for total revenues of $5.6 billion. The combined climate and health costs of burning 186.7 million tons of coal are about $30 billion, so—taking total revenue as a measure of total value creation, which is conservative—Peabody is destroying at least five times the value that it is creating.

Every time you use fossil fuels—whether it's to drive a car or to take a flight—you are creating lasting damage that you are not paying for. The production of every ton of steel, every ton of cement, and every single hamburger—to focus on a few products that are particularly energy intensive to produce—creates significant damage that isn't included in the price. The production of every cheeseburger generates approximately the same emissions as half a gallon of gasoline, and beef consumption alone is responsible for about 10 percent of global GHG emissions (and only about 2 percent of calories consumed).

When you add these costs to the bottom line, it turns out that nearly every firm is causing significant damage. In 2018, for example, CEMEX, one of the largest cement companies in the world, emitted more than forty-eight million tons of CO_2—despite the fact that in 2018 about a quarter of the electricity used in its cement operations was generated by renewables. That's at least $4 billion worth of damage. Its Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) that year was $2.6 billion. In fiscal year 2019 the total emissions of the UK retail chain Marks & Spencer—a company that has been working hard to reduce emissions for years—were equivalent to 360,000 tons of CO_2. That's about $32 million in damages. Pretax profits in the same year were $670 million.

The distortion caused by the failure to price GHG emissions is enormous. Prices across the entire economy are completely out of whack. If the free market works its magic through the fact that prices capture all the information one needs to know, in this case there isn't much magic in evidence.

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Markets only create genuine freedom of opportunity if everyone has the chance to play. When unchecked markets leave too many people too far behind, they destroy the freedom of opportunity that is fundamental to their own legitimacy. The world is immensely richer than it was fifty years ago, and inequality between countries has fallen significantly. In the 1950s half the world's population lived on less than $2 a day. Now only 13 percent live at this level, and most people have a decent subsistence. But within countries inequality has jumped to levels not seen since the 1920s. In the United States and the United Kingdom, for example, the benefits of productivity growth have gone largely to the top 10 percent while real incomes have stagnated.

In the United States social mobility is now significantly lower than it is in Canada and northern Europe, but it has fallen nearly everywhere. The winners from the economic boom have increasingly found ways to pass their success on to their children, so that a child's success is increasingly a function of the zip code where they were born and their parents' income. Only 2-4 percent of students in the eight Ivy League schools' class of 2013 were from the bottom twenty percent of the income distribution, while between 10 and 19 percent of the class had been born to families in the top 1 percent.

A student born to the top 5 percent of the income distribution has about a 60 percent greater chance of joining the 1 percent than a student whose parents' income was in the bottom 5 percent, even if they both attended one of America's most highly regarded universities. Your health is increasingly determined by your zip code. To take just one example in: In 2017, the life expectancy of the residents of the poorest sections of New Bedford, Massachusetts, was slightly less than the life expectancy in Botswana and Cambodia.

It has also become significantly harder for entrepreneurial firms to succeed. Between 1997 and 2012, the four largest firms in every sector increased their share of the sector's revenues from 26 to 32 percent. Young companies were 15 percent of the economy in 1980 but only 8 percent in 2015. This increase in concentration is also reducing workers' bargaining power—and with it, both benefits and compensation—while driving up profits and prices.

Markets are only free and fair if the players can't fix the rules in their own favor. In 2014, for example, two political scientists published a study exploring the relationship between popular support for a policy and the odds of it becoming law. The views of the "average citizen" in the United States, they found, don't matter at all. Proposals supported by 90 percent of the general population are no more likely to pass than proposals supported by 10 percent. But if the rich wanted something done, it got done.

Spending the money to change the rules of the game in your favor can be a fantastically effective way of making money—even if it imposes significant costs on everyone else. In 1997, for example, the Walt Disney Company lobbied heavily in support of an obscure piece of legislation called the Copyright Term Extension Act (CTEA).

Giving artists and authors (and filmmakers) copyright in their creations allows them to profit from their ideas—giving them the incentive to create more. But copyrights are limited so that after some reasonable period of time, other artists and authors can build on the ideas of those who have come before them. In Disney's case, for example, the movie *Snow White* is based on an old European folktale. So is *Beauty and the Beast*.

The CTEA promised to extend US copyright to the life of an author plus 70 years, and to extend corporate copyrights to ninety-five years. For Disney, which was facing the risk that its most beloved—and most profitable—characters would start coming off copyright in 2023, the bill offered an additional 20 years of protection.

Disney spent slightly more than $2 million lobbying for the bill—pushing so aggressively for its passage, that it laughingly became known as the "Mickey Mouse Protection Act."

The bill ultimately sailed through Congress and was signed into law on October 27, 1998. My rough estimates suggest that at the time it passed, it might have been worth as much as $1.6 billion of additional income to Disney—not a bad return on slightly more than a $2 million in investment There is no evidence, however, that it increased the general welfare. Rather, the reverse. Disney had argued that delaying the moment until competitors could copy its films would increase Disney's incentives to create new ones. But a group of prominent economists—including five Nobel laureates—argued that the extension had had essentially no effect on the incentives to innovate. In their words, "In the case of term extension for existing works, the sizable increase in cost is not balanced to any significant degree by an improvement in incentives for creating new works."

In plain language, Disney—a firm that prides itself on it wholesome family image and whose theme parks are practically a required stop for every family in the United States—has essentially laid the groundwork for charging these very families somewhere north of a billion dollars to enrich its own investors without generating anything like a comparable social benefit.

Still, this is just money. The fossil fuel companies have been pursuing a similar strategy with much graver consequences for the world. Between 2000 and 2017, the fossil fuel industry as a whole spent $3 billion lobbying against climate change legislation, and millions more backing groups and campaigns that denied the reality of climate change.

As of this writing, Marathon Oil, the largest oil refiner in the United States, publicly acknowledges the reality of climate change and claims that it has "invested billions of dollars to make our operations more energy efficient." But it has been a vigorous supporter of the current administration's attempts to roll back existing regulations on automobiles emissions, suggesting on one call to investors that the rollback would increase industry sales by 350,000 to 400,000 barrels of gasoline a day. Such an increase would impose costs of between $4.3 and $4.9 billion on the rest of the world, but a price of roughly $56/barrel would increase industry sales by between $6.9 and $7.9 billion. In Washington state, oil interests outspent their opponents by two to one to defeat a measure designed to impose the first ever US carbon tax, with BP alone contributing $13 million to the effort.

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It's not only money that allows firms to buy favorable rules. In many situations the issues are so highly technical, so narrow, or so dull that neither the media nor the general public cares much about them. For example, changes in accounting standards are hard to understand and rarely arouse much public interest. But seemingly minor changes in accounting rules were one of the causes of the Great Crash of 2008.

Profit maximization only increases prosperity and freedom when markets are genuinely free and fair. Modern capitalism is neither. If massive externalities go unpriced and uncontrolled, if true freedom of opportunity is more dream than reality, and if firms can change the rules of the game to suit themselves at the expense of the public good, maximizing shareholder value leads to ruin. Under these conditions firms have a moral duty to help build a system that supports genuinely competitive, appropriately priced markets and strong institutions. They also have a compelling economic case to do so. **A world on fire threatens the viability of every business.**

Excerpted from *Reimagining Capitalism in a World on Fire* by Rebecca Hendersoni.

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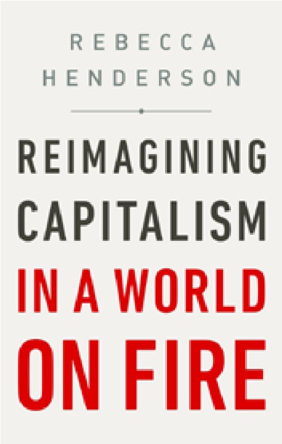

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Rebecca Henderson is the McArthur University Professor at Harvard University (the highest honor that can be awarded to a faculty member), where she teaches the acclaimed course on "Reimagining Capitalism." Henderson spent the first twenty-one years of her career at MIT's Sloan School where she was "teacher of the year" and where her research focused on the economics of innovation and on the question of how large organizations can reinvent themselves. Henderson's academic career is complemented by a deep engagement with the practice of management. She has been on the boards of Amgen, a Fortune 200 company, for eight years, and Idexx, an S&P 500 company, for fifteen. She has also consulted with a wide variety of companies including IBM, Motorola, Cisco, Nokia, Eli Lilly, BP, ENI, Unilever, P&G, and many smaller firms, and is routinely invited to speak to executives across the world.

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