CAPITALISTS ARISE!

PETER GEORGESCU

For the past four decades, capitalism has been cannibalizing itself. It's going on in plain view and yet no one is talking about it because only a few people recognize what's happening. Those few are either very troubled or very scared. The bull market is setting historical records, and the unemployment rate seems reasonable again, so most casual observers—meaning almost all of the media—think America is back on track and growing. Nothing could be further from the truth.

The stock market isn't an accurate measure of anything but how much profit we can extract from a business model that is undermining our society. And yet we assume stock prices indicate a sustainable corporate and business success. Quite happily we gloat with pride as the Dow sets new records. Growth in the value of stocks has become an obsession, a false measure of how well we are doing—about as sensible as thinking a suntan indicates good health. Quick profits have become all important. Year in and year out, quarter after quarter, profits must go up. As a result, a CEO pushes earnings and stock prices skyward by whatever means possible. Do that consistently, and the CEO is richly rewarded, celebrated in the press, and applauded by the financial community. Any CEO who allows earnings and profits to languish, even temporarily, is in danger of losing his or her job. That has become our zeitgeist—deliver earnings, push up the stock price, or perish. It has the appearance of a natural, reasonable process, but it isn't.

It is a cruel and self-destructive way to do business. It's leading us to disaster. This is a world in which shareholders have come to demand, and get, maximum, short-term returns. A world where shareholders have dominion over all other stakeholders in a company. Nearly four decades of this version of capitalism have damaged the long-term viability of businesses and helped create a vast, unequal America in socioeconomic terms. Simply put, shareholder primacy has become a kind of cancer that needs to be eradicated before it destroys our way of life.

To say this within the world of business today is tantamount to pointing out, centuries ago, that the earth was actually round.

Shareholder primacy has become so fundamental to the way we've thought about business for nearly half a century that most of those in business are hardly more aware of it than they are of the air they breathe. Meanwhile, this philosophy has been destroying the conditions that create new markets and healthy communities for the companies that make their shareholders wealthy. If that surrounding way of life collapses, profit isn't sustainable. It will disappear along with the company creating it. What makes our corporations appear to be strong and successful is actually eroding the ability of the general population to spend, to thrive, to hope for a better future. For the majority of our people, the American dream has simply disappeared.

Opportunity has disappeared because free market capitalism has been hijacked.

Our system thrived in the 40s to the 1980s, when America became the greatest engine of prosperity in the history of the world. In the late 70s, that began to change as we narrowed our vision and started to focus solely on rewarding shareholders. What we desperately need now is not to abandon free market capitalism, but to correct its vision: to restore its broader sense of responsibility to multiple stakeholders, to our society as a whole.

Corporate profit margins are at an all-time high, even though the economy has almost stalled, and wages have barely kept up with inflation. Despite the extraordinary rise in income and wealth for the top quartile of earners in America, the median household income is less than 1% higher than it was in 1989. Wages have stayed flat, or have declined, since mid-1970. Since the 2008 financial crisis, 91% of income growth has gone to the top 1% of earners.

As a result, in a desperate ploy to feel as if they're getting ahead, most households are sinking deeper and deeper into debt. Nearly 60% of the population is staying afloat through deficit spending—to put food on the table and pay they bills, they have to borrow money. We don't have "extreme poverty," like some developing nations, but half of our population is sliding toward insolvency.

On top of all this, America ranks highest for socio-economic immobility and income inequality among developed nations. We have become the Land of Lost Opportunity.

Four decades ago, America offered the greatest social mobility in the world. Work hard and you could advance into more responsibility, higher income, and a better standard of living. Except for the elites, there are few chances to move up the social ladder today. Alongside our debt, this is probably the most troubling measure of our economic health.

The extraordinary creator of wealth—free market capitalism—no longer works for anyone but the people at the top. On a global basis, the world is making dramatic progress in reducing poverty. It's an historic and phenomenal accomplishment for mankind and for the principles of free market capitalism, which have driven the rise in quality of life almost everywhere. Here in America, though, it has slowed to a crawl.

Capitalism built the strongest, most affluent middle class in world history. Now the American middle class is dying—as it is in Europe.

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We can reverse all of this if the private sector wakes up to its responsibility. Companies have to recognize that their workforce, the employee, is the source of success—not simply another cost on the income statement. Business can start to save capitalism in two fundamental ways:

1. **First, invest in the actual value creators—employees.** Start compensating fairly, by which I mean a wage that enables employees to share amply in productivity increases and creative innovations.

2. **Second, businesses must invest aggressively in their own operations,** directing profit into productivity and innovation to boost real business performance and grow more and more creative jobs.

Shareholder primacy has become one of the major drivers of income inequality and the dearth of economic opportunity for many in America. The unrest and anger that determined the outcome of the 2016 presidential election are in part the result of the destructive consequences of shareholder primacy, which has been turbocharged by the negative effects of globalization and technology.

It's no wonder that our universities are turning out generations of young Americans who believe capitalism is evil. Thomas Piketty's book *Capital in the Twenty-First Century* only reinforced this view in its central thesis that our economic system increasingly concentrates wealth within

the pockets of a smaller and smaller percentage of the population—those who demand and get a disproportionately large share of the profit, rather than those who do the work that creates it. And they use their wealth and power, economically and politically, to perpetuate their plutocratic status. Hope for a better life has been all but extinguished for most, though not because the system of free-enterprise capitalism is inherently self-destructive. Opportunity has disappeared because free-market capitalism has been hijacked.

Five or six decades ago, our most successful companies felt an allegiance to a variety of stakeholders—employees, customers, the corporation itself, communities, the nation and, of course, the shareholders. By operating with an imperative to strengthen all of these constituencies, our system thrived in the late 1940s through the 1970s, when America organized itself into the greatest engine of prosperity in the history of the world. In the late '70s, all that began to change. That's when we narrowed our vision and started to focus solely on rewarding shareholders. We are experiencing now, as we have stated throughout this document, a growing socio-economic gap between the elites and the vast majority of our citizenry. What we desperately need now is not to abandon free-market capitalism, but to correct its vision—to restore its broader sense of responsibility to multiple stakeholders, to our society as a whole.

I'm not the first to suggest this. Many advocates for "stakeholder primacy," as it were, have been pointing toward shareholder primacy as a villain. Among others, Lynn Stout at Cornell Law

School and Judith Samuelson of the Aspen Institute have been decrying this philosophy for years and pushing for a new sense of responsibility in the executive suite. Organizations such as JUST Capital have sprung up to push for a wiser form of corporate governance. Even Jack Welch, the former CEO of General Electric, has famously called shareholder primacy "the dumbest idea in the world." Yet, so far, little has changed. Most business leaders protect their jobs by going along with a system that rewards them with equity, so by squeezing every last penny of profit from a firm before its next quarterly report, the executive's own compensation increases in proportion to the rise in the stock price. If they don't act for short-term gain, and instead take responsible steps to build a company with long-term viability, they fear they will be replaced. And they have legitimate reasons to fear the wrath of the financial community and its radical shareholder activists. They are brutally unforgiving.

Yet, taken as a whole, our business community fails to recognize the tremendous upside in moving away from the short-term mentality that has ruled the commercial community for nearly as long as current leaders have been in business. What's missing is a recognition in our business community of the happiest irony in this story: only by abandoning short-term shareholder primacy will a company find its path to greater profits down the road, while supporting society, helping to re-create a viable middle class, and rekindling hope in the American dream.

All of this was confirmed for me not long ago at the Aspen Ideas Festival when I heard Zeynep Ton describe an almost identical vision of how success rests on the shoulders of employees. Her talk was based on her book *The Good Jobs Strategy: How the Smartest Companies Invest in Employees to Lower Costs and Boost Profits*. This brilliant young professor from MIT's Sloan School of Management was preaching what I consider the new gospel for our private sector: recognize and reward the supreme importance of employees. In the process of doing exhaustive research into how American companies were finding wholesale access to products for resale to customers in the United States, she discovered something disheartening. She told *The Atlantic*: "You could get a product all the way from China to the store, and then the product would get stuck in the back and never make it to the floor. For a supply-chain person like me, this was heartbreaking."

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What had enabled a company to find the best supplier—by seeking the lowest-cost alternative—ended up foiling the entire strategy? Unmotivated, uncaring employees were sabotaging the company's success because they had been treated as if they were the same as the supply chain—a cost. Their morale was at rock bottom.

Ton saw the havoc this caused and realized that a company's fortune now pivots around the enthusiastic creativity of its employees. By recognizing employees for making crucial decisions and encouraging them to be the concierge for a customer's satisfaction, and to embrace responsibilities that impact the bottom line, you can create a culture that justifies and necessitates higher pay. But higher wages alone won't cut it. Employees must feel that they are creating value for customers and the company every hour of the day—they must know they are earning higher wages for a reason.

The objectives of enlightened capitalism are simple and clear: to build a devoted, loyal, motivated, and creative workforce. You do this by compensating and treating employees appropriately, while investing more aggressively in R&D. The goals: sustained innovation and the growth it generates. The challenge for those who run our companies is how to get down to a more granular level: specific actions a CEO might take. What follows are possibilities. No single suggestion can fit every organization's unique character, its stage of life, and its competitive environment. Still, the majority of these suggestions can be implemented to some degree in most companies.

Most importantly, business, not government, must set the agenda for how companies should compensate their workers. Each company needs to adapt and adjust to the new normal with its own wisdom and flexibility, given the dynamics within that company and its industry. In addition, consideration should be given to the most efficient and effective way to improve compensation for employees outside the C-suite.

The first imperative is to increase compensation for employees making $100,000 or less. The source of these funds would come from a reasonable, incremental sharing of productivity and innovation gains—in other words, when leadership finds new ways to increase profit through efficiency, share it with employees as well as stockholders. (A decrease in the cost of financial engineering by throttling stock buybacks and lowering dividends could be shared this way as well). Depending on circumstances, the increase in compensation can be made in cash or equity—a form of restricted stock, for example. It could be a five-year plan that has a sunset and is reevaluated before continuing with appropriate improvements.

There are two fundamental concepts for how we can do this in a fair and just way. The first is a fair wage: that means sharing the incremental value produced by the organization as a result of productivity or innovation. That is fair value. The second way to do this is through a living wage. This applies to the lower end of the pay scale. Individuals should take home enough in wages to pay their bills, pure and simple. A living wage shouldn't be a single number across

the board; it can differ depending on cost of living situations, based on different locations. Manhattan and Peoria will have different wage scales to achieve a living wage. So would Mumbai and Paris. We should think in those terms for everyone. A living wage must be realistic but also be perceived as generous in the context of its local and regional setting. Let me put it another way: pay people enough that it makes them feel lucky and privileged to work for you.

The plan would begin with meaningful yet modest raises, which would increase in size as the plan reaches its “new normal” for the percentage that’s shared from gains from incremental revenues and profits. The new normal should be decided on the basis of long-term economic growth, not simply short-term profit. Over a period of time, the increases in the fair-wage concept should go all the way up to the C suite. Rewards for real productivity and innovation should be awarded to all employees. The plan should be communicated broadly both inside the organization and publicly to the market and the general public. Companies that take steps like this will find a media eager and willing to celebrate whatever helps the American worker and the middle class.

Meanwhile, the culture needs to shift toward a focus on long-term growth in real value. This means changing the mindset of management and the organizational culture. As an example, a first step could be to ask the CEO’s direct reports for their two best ideas for how to dramatically strengthen the corporation’s long-term growth prospects and competitiveness. Select two or

more of the projects for beta testing or outright implementation. Measure the progress of the projects and report broadly the projects' status against preset value-added metrics.

With this longer-term operating vision, develop rigorous multiyear operating plans. Demand from the organization ambitious goals for both existing businesses and innovative new products/businesses. Communicate to the market the vision, critical strategies, and targeted milestones along the way. Then, share equitably the incremental outcomes with leadership, all employees, the corporation's R&D needs, and shareholders.

Gradually manage to raise shareholder value while increasing investments in all employee compensation and corporate/product investment needs. This will redefine the parameters of how to measure long-term shareholder value and make growth more sustainable.

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Behind all this has to be a strategy of building underlying assets:

- ➔ Measure annually the underlying value of the active corporate assets. For example, annually monitor the value of the corporate brand and, most importantly, the value of a corporation's product or service brands. These tools are already available: the Brand Asset Valuator developed and used for years by Young & Rubicam.
- ➔ Develop specific action plans to leverage those brands and recognize and reward innovations and the value creators. But start with measuring the brand's performance on a regular basis.
- ➔ Though it isn't possible to offer remedial education to applicants who simply aren't qualified—for example those who can't read and write proficiently—a company should make continuing education a core element of its benefits program for all employees.
- ➔ Train employees/prospective employees for anticipated skill-level needs and develop partnerships with various educational institutions to help execute such plans. In Spartanburg, South Carolina, BMW has been running a special trade-school program. They take local high school graduates and put them through two years of training to become apprentice mechanics. When they graduate, these young men and women are in most cases guaranteed full-time jobs at a pay rate above the national average.

- ➔ When terminating employees, provide for appropriate training or retraining of new or existing skills demanded by the marketplace.
- ➔ Embrace the concept of continuing education to increase value creation at all levels in the organization.

Finally, restructure executive compensation to reward long-term growth not short-term profit. Offer vesting of stock allocation over time. Peg salaries and bonuses on measures of long-term viability, not only on quarterly earnings growth. Examples of such goals:

- ➔ Sustained profitability growth.
- ➔ A more natural balance of employee compensation, R&D investment, and shareholder return.
- ➔ Improvements/growth of underlying assets (brands).
- ➔ Other critical elements of the annual plan specific to industry and the company's competitive needs.
- ➔ Tie CEO compensation to long-term objectives, not short-term gains.
- ➔ Percentage increases for top management cannot be larger than the percentage increases for all other employees.

This all sounds fine, but do these "experiments" in a new interpretation of free-market capitalism actually work? Well, the data says yes. A remarkable book, *Firms of Endearment: How World-Class Companies Profit from Passion and Purpose*, tracks forty corporations that focus on all levels of "value"—emotional, experiential, social, and financial. These companies (referred to as FOEs) serve all stakeholders, and their overall returns, outlined in figure 15, show how their shareholders have been rewarded even more generously than those of companies focused on shareholder primacy.

Annualized Performance	15 YEARS	10 YEARS	5 YEARS
US FOEs	21.17%	17.69%	20.24%
Internal FOEs	18.53% 1	9.86%	20.46%
S&P 500	5.32%	7.55%	9.98%

Annualized Returns (10/1/98 to 9/30/13)

Similarly, a brilliant not-for-profit, Just Capital, measuring top 1,000 corporations on what the American people consider a "just" business organization, proved the same point. A 30-plus percent better shareholder annual return for the most just companies in their industries.

More motivated employees, backed by higher investment in the long-term future, produce greater profits and happier stakeholders. The purpose of business isn't simply shareholder value, by

any means: it's a matrix of outcomes, not only for owners and shareholders, but also for employees, customers, communities, and the environment. A company has to benefit everything and everyone it touches. First and foremost are its employees. Their lives depend on being able to earn a fair wage, and our economy depends on their ability to keep earning those wages.

A few years ago, a quiet private-sector revolution took place in Boston. Market Basket, a grocery retailer, has stores in the Boston area and parts of New Hampshire. The company is family owned, extremely successful, and quite profitable. The ownership was divided among family members, including the CEO and five others. Disagreements grew heated between two camps that split the family apart. All five of the other family members teamed up with a consultant to argue against the CEO on several points:

1. **The company was buying only top-quality produce.** If they lowered standards a tier or two, they could cut costs in ways that customers wouldn't notice.

2. **Employee salaries were too high.** They wanted to reduce pay scales and benefits when hiring capable replacements.

3. **The company employed more people than it needed on the floor.** Competitors didn't feel the need to have as many people to help customers navigate the aisles.

There were a number of other issues as well, all directed toward boosting profit by lowering quality of service.

The CEO refused to accept these suggested measures. He argued that none of them could be implemented without harming service and the quality of products customers knew they could find at Market Basket. As a result, the CEO was voted out—fired by the other insurgent family members.

This assault on the culture that the CEO had spent many years building gave rise to a startling, friendly uprising. The established employees, who were also fired or knew they were about to be let go, began picketing the stores. What happened next was virtually unique: customers joined them in the picket lines. Not only that, many of these customers began shopping at competitive supermarkets and then defiantly taping their grocery receipts to the windows of their favorite Market Basket store. Within a few weeks, the company was bleeding cash. The governors of Massachusetts and New Hampshire anticipated where all this would lead. They had no desire to see Market Basket fall into bankruptcy, with thousands of employees left unemployed. So they stepped in to help negotiate a settlement. The CEO's faction within the family bought out the dissident shareholders, and the company returned to normal—albeit with debt it must now work off.

The result: all the loyal customers came rushing back, followed by new customers who had read about this remarkable intramural battle on their behalf. Employees hailed the CEO as a hero and doubled their daily devotion to customer satisfaction.

It's almost a parable of how business can, and should, be run—and why it works. It's about human relationships—between management and workers, as well as a company and its employees. Shareholders who lose sight of that primary truth, as so many have been doing over the past four decades, risk everything in the pursuit of easy profit. The role of business cannot be simply to maximize short-term profits on the backs of employees and customers. Too many corporations have forgotten how the Golden Rule essentially serves as the core value at the most enlightened companies. Doing the right thing for others eventually brings sustainable growth and profitability.

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Executives, directors, shareholders, and others must take steps to push back against the pressures of shareholder primacy and begin to reshape free enterprise with a vision that looks to long-term profitability rather than short-term gain. We need an enlightened capitalism that recognizes its responsibility to multiple stakeholders, not just shareholders. Many companies are already on the way toward it. Importantly, the powerful equity holders must speak out and support the companies that do it right, with their deeds and their words. The reality is that the current shareholder-primacy model is a disaster, and it is also not sustainable. Society will soon demand change through the ballot box or in the streets. The enduring lesson of these unfortunate decades for the majority of Americans is clear. Business and society cannot operate independent of each other. Long term sustained growth and prosperity can only be realized when both business and society thrive. By reimagining free-market capitalism, business can help heal our economy and our society—and ensure lasting profits into the future. **It is time for capitalists to arise; we need to do it now.**

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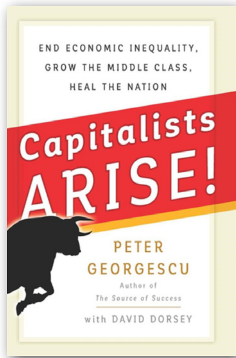

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ABOUT THE AUTHOR | Peter Georgescu is chairman emeritus of Young & Rubicam. He served as the company's chairman and CEO from 1994 until January 2000. In recognition of his contributions to the marketing and advertising industry, he was elected to the Advertising Hall of Fame in 2001. Georgescu has been the director of the board for eight public companies, among them Levi Strauss, IFF, Toys"R"Us, and EMI Recorded Music. He is currently vice chairman of New York-Presbyterian Hospital, a trustee of the Paul and Daisy Soros Fellowships for New Americans program, and a member of the Council on Foreign Relations. He is the author of two previous books, *The Source of Success* and *The Constant Choice*.

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