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FOUNDATIONAL CONCEPTS TO GUIDE POLITICS AND POLICY

Stakeholder Capitalism: Theft, Path to Central Planning, or Both?

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Stakeholder capitalism is being pushed both by ideological partisans who have little respect for ownership rights and, perhaps worse, by those who would benefit financially from more exclusionary capital markets. Moreover, the managerial incentives created by environmental, social, and governance (ESG) initiatives are likely to hurt all constituencies to the benefit of managers who are charged with overseeing their implementation. Still further, the ESG movement is poised to create a toxic mix of government and business, the end result of which will be the broad destruction of social value and a decline in human flourishing.

> The directors of [corporations]...being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it.
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> —Adam Smith, *The Wealth of Nations*[1]

Certain groups are calling upon today's corporate directors to use corporate assets in pursuit of a panoply of environmental, social, and governance

(ESG) goals, but these goals have not been defined by standard democratic protocols. Instead, they are offered as *ipse dixit* with the assurance that they will yield widespread benefits if achieved. Many of these goals have been lurking in the halls of government for decades without success, and their appearance in corporate boardrooms raises important concerns. The "governance" part of ESG, for example, is remarkably vague, at best defined as a requirement that management accept the *en vogue* "environmental" and "social" party line.

Securities and Exchange Commission Chairman Gary Gensler has said that "[w]hen it comes to climate risk disclosures, investors are raising their hands and asking for more."[2] *The Economist* reported that proposals for mandated environmental disclosures "appeal to financiers."[3] This is correct and unsurprising. Large asset managers like BlackRock promote their ESG bona fides, in the process espousing[4] "investment access" and "inclusive economies."[5]

But the risk created by coercing ESG adoption may damage markets and the social order by incentivizing exclusionary and economically inefficient behavior. For example, ESG can meaningfully change the behavior of firms only if those firms are able to change their behavior at a reasonable cost. For firms that cannot change to comply fully with ESG demands—fossil-fuel producers can eliminate their fossil-fuel footprints only by ceasing to produce fossil fuel—financial ruin is their only payoff, and the world that needs those industries to flourish will suffer if the ESG movement achieves its goals.

Financial markets are fundamentally distorted by ESG's artificially inflating the cost of being a public company subject to regulation, public pressures, or both. If checking ESG boxes is too expensive, providers of capital for new businesses will never agree to take them public, and existing public companies may reprivatize, reducing the options available to public investors.[6] This trend has likely already started, with the number of publicly traded companies having declined 50 percent in the past 20 years.[7] Most of the decline is from the disappearance of small firms.

Unfortunately, average investors will be the ones with ever fewer investment options, while professionals and those with high net worth ("accredited investors"[8] in SEC-speak) get to invest privately. It should therefore not be a surprise that asset managers serving the wealthy favor ESG initiatives. ESG, in other words, serves to build a "bigger moat" between those who are able to bear its costs and those who are not.[9]

Moreover, if ESG-focused capital—whether provided by genuinely ESG-conscious investors or by those who care more about greenwashing[10]

(or pinkwashing[11] or bluewashing[12])—departs disfavored firms, arbitrageurs will see unlocked value. In firms that are able to attract new capital from what ESG pressures turn into a smaller pool of available investors, the new owners may be, for example, foreigners who have little concern even for basic environmental cleanliness in the U.S. The ultimate result, then, can easily be worse overall environmental outcomes and the departure of capital to nations without ESG burdens.

In sum, rather than enhance human flourishing, ESG can harm it—more so if businesses meeting human needs and wants are hurt by ESG's burdens and rhetoric. But how can such a situation come about, and might the harms of ESG be worth its benefits? These questions are discussed next.

Managerial Incentives

As the early pioneers of public choice theory established, individuals do not surrender their self-interest when they participate in government functions—James Buchannan famously coined the phrase "politics without romance."[13] The same holds true for their participation in the corporate form. Whether part of the internal corporate governance structure, a contractual counterparty of the corporation, or even an external group, those who can benefit from corporate action will petition corporate managers to shift corporate policy in ways that provide private benefit rather than corporate gain. This obvious parallel to government has gone unremarked and unexplored for too long.

The foundations of "corporate governance without romance" begin with Adam Smith, who recognized managers' self-interest and the way in which their incentives are inherently misaligned with those of stockholders. Stakeholder capitalism argues that companies should optimize more than profits for shareholders but create value for all of their stakeholders (employees, customers, local communities, suppliers, etc.) and even for the overall society. ESG is one virulent manifestation of this understanding.

ESG undermines key corporate governance institutions that have long served to realign the incentives between managers and shareholders. These institutions exist because humans tend to want the most reward for the least work. This truth pervades most economic analyses but is absent from most modern ESG debates or other discussions of stakeholder capitalism. ESG advocates recognize this propensity at the corporate level—thus their advocacy for more than profits—but peculiarly ignore the danger when it comes to managers' being empowered to implement the advocates' preferred policies.

Corporate managers control firm assets. Every constituency wants a portion. Some have legitimate claims on corporate assets, based on previously established contractual obligations. Suppliers of inputs, for example, are entitled to payment in exchange for that which they provide to the corporation. Employees, including managers, fall into this category, having provided their labor and human capital in return for wages, but ESG, as a form of stakeholderism, implicitly recognizes claims on corporate assets that neither have a clear description nor are tied to a specific contribution to the corporation.

Central to the question of what is owed to various claimants on corporate assets is the question of what is owed to shareholders. Commonly understood to be the firm's "residual claimants," shareholders are entitled to the value left over after all other claimants have been paid. When corporate assets are diverted—without express shareholder approval—to ends that do not increase corporate value, shareholders' return on their investments are diluted without their consent. Society has long had a simple term for this: theft.

Who Owns What in the Corporation?

This bold claim—that stakeholder capitalism often leads to theft—is justified if shareholders own the assets that are used to satisfy the demands of other claimants. That, in turn, requires an analysis of property rights within the corporation. Property is often thought of as a bundle of rights—to exclude, to derive income from, to dispose of, to name a sample[14]—including by the U.S. Supreme Court.[15] The corporation is often described as a "nexus of contracts"[16] but is better thought of as something more: a nexus of property, contract, and associational rights.[17]

At the time of incorporation, a corporation is nearly indistinguishable from its shareholder-founders. They possess all the rights in the corporate bundle, including the right to run it as they please. This is true whether the firm is a family farm held in the corporate form or a new subsidiary of a global firm. The founding shareholders appoint a loyal board of directors, which may be themselves. They control the firm's activities and assets, police employee behavior, and reap or suffer the corporation's profits or losses. The founders are the ones with the special resources, skills, or ideas around which the new venture is started. They contribute these to the corporation, intending to see a return on their investments.

If successful, the corporation will expand and outstrip the ability of the shareholders to maintain adequate oversight of operations.[18] They will need

help in the form of professional managers. They will, of necessity, surrender day-to-day control rights to those managers. It does not follow, however, that shareholders, having surrendered day-to-day control, will have surrendered any other rights.

The shareholder-founders created the corporation in part as a mechanism for achieving their joint goals, including earning a return on their investment. The right to have the corporation pursue that end passes, with all other rights, from the founders to successive shareholders and remains with shareholders unless and until there is reason to suggest that they have exchanged it for something of equal or greater value. Shareholder-owners are entitled to the wealth generated by their corporation absent an explicit agreement to the contrary.

Most midstream shareholders, who invest in public corporations with no hope of being able to exert control, are motivated by profit[19] as were the founders. Self-interest, broadly understood and as articulated by every economist since Adam Smith, argues in favor of shareholders' retaining the most versatile right in their bundles: a complete return on their investments. It is most naturally the right that they would relinquish last. Consequently, neither founders nor successive shareholders can be assumed to surrender their rights to a full return on their investments to managers or other constituencies absent strong evidence to the contrary.

But aren't individuals motivated by nonmonetary goals? Is there no room for charitable desires? Of course, the answer is "yes" to both, but the wealth that is the legitimate pursuit of all corporations allows stockholders to pursue nonwealth social goals without self-interested management or regulatory intermediaries deciding which of *their* favored causes to support. Left to their own devices, boards can generally be expected to cause corporations to donate to operas and museums rather than soup kitchens and homeless shelters. Shareholders know better than managers which causes shareholders want to support. In most instances, it will be more efficient for shareholders to make money through share ownership and donate their investment returns as they prefer to invest them.

Mixing Government and Business

The ESG movement and stakeholder capitalism more generally shift the locus of political battles from the halls of government to the boardroom, causing the corporation to be a political entity rather than an economic one. Although the Supreme Court has indicated that corporations have a constitutional right to participate in political debates,[20] this does not

mean that doing so is wise or useful, especially when firm goals are imposed from without as part of a larger political movement, and the mixture is still problematic.

Even within the corporation, taking sides in political battles is generally unwise. At the most basic level, politics is divisive; taking either side in any political battle will marginally improve the corporation's standing with potential customers who support its position. Those individuals will then be marginally more likely to buy from the firm. At the same time, however, the corporation's standing will marginally decrease with the opposite side of the debate, reducing the likelihood that those individuals will purchase from the corporation. It is difficult to know what the ultimate impact on the corporation's bottom line will be.

Managers asked to inject the corporation into political battles cannot reliably know either the political preferences of consumers or their intensity. Similarly, managers at best have only hints about the consumption preferences of consumers and their intensity. To have any confidence in the net effect of taking a political stand, managers would need to know all of the above. That knowledge need not be perfect, but it would need to be substantially better than what managers can reasonably obtain. The high uncertainty regarding the marginal impact on corporate profits puts the lie to managerial claims that these decisions are just good business.

The same uncertainty surrounds shareholder preference on these political issues unless the corporation was created with those preferences declared in its corporate charter. Alternatively, if a corporation shifts midstream and is able to obtain unanimous support of its shareholders for taking sides in political battles, shareholder preferences might be known with enough certainty that management could claim that turning the corporation into a political entity is in keeping not only with shareholder preferences, but also with their own fiduciary duties to the corporation. In all other circumstances, however, the choice to engage the corporation in political battles is likely to be an expression of the managers' personal preferences in violation of their fiduciary duty of loyalty to the corporation and its shareholders.

At one level, the intensity of pressure for political engagement is greater than ever, but the phenomenon of managers using corporate funds to express the political preferences of management is not new. As early as 1905, the Great Wall Street Scandal revealed that corporate managers were using corporate funds both for personal gain and to aid political campaigns.[21] Society—beginning with public opinion but extending to media and to religious and political leaders, including then-President Theodore Roosevelt—erupted in opposition to managers' engaging in what amounted to theft or embezzlement.

Managers, then as now, defended themselves on the ground that they were just seeking to further the interests of owners. Also, then as now, managers who engaged in this behavior were creating "forced political association" between shareholders and candidates or policies that shareholders would not choose for themselves. Finally, then as now, measures were needed to "protect [shareholders] from *their own servants*."[22]

Excluding Dissenting Investors

ESG policies are presented as a path into which corporations can opt. As discussed, there are reasons to question whether stakeholder capitalism, broadly speaking, is ever legitimate or organic. Moreover, because it bundles products with moral or political stances, it can limit its accessibility and exclude investors and consumers whose values conflict with the corporation's new moral stand.

In a free and competitive financial market, that some investors do not feel comfortable investing in a particular company is not necessarily cause for alarm. After all, an investor who is unwilling to invest in one corporation will simply move on to the next, so the investor has not been harmed. The corporation, however, will pay a cost commensurate with the divisiveness of the moral debate into which the corporation has stepped. A higher level of division means more excluded investors, exerting downward pressure on demand. Unless that reduction in demand is countered by an increase in demand from those who agree with the managers' decision, the corporation's stock price will decline, and the corporation will become a more attractive takeover target.

Moreover, if political pressures become strong enough, even managers who would rather keep their corporations out of political battles may feel compelled to join the fight on the "approved" side. If that happens, diversity of opinion and, thus, competition in moral questions will decline. If entrepreneurship in this area is permitted, new options will emerge to take advantage of the premium that is available due to the pent-up demand.

If, however, legal or regulatory barriers[23] to this kind of entrepreneurship are put in place, there may be no place left for dissenting investors to go, at least in public financial markets. If their moral opposition to the day's ESG goals is weak, they may eventually succumb and begin to invest where they feel uncomfortable. That outcome will not be without its problems—notably, a less robust marketplace of ideas and less diverse investment regime—but it will be better than the alternative: a significant number of average investors simply exiting from financial markets. Wealthy and connected investors will

have the option of investing privately, but dissenting average investors will face a choice of investing abroad or simply consuming their wealth rather than investing. Neither option is efficient.

Breaking Down Corporate Governance Institutions

The exclusionary effects of ESG create its greatest dangers. First, ESG allows various corporate constituencies' rights to be commandeered by rent-seekers. The term is one used by economists to describe the inherent human desire, described above, to obtain greater benefit than is justified by one's productive behavior. From managers to employees, from shareholders to external "stakeholders," each one wants rents—something greater than what they have earned through voluntary contract with the corporation. Corporate assets are limited by the productive effort of the combined corporate enterprise, so seeking rents requires excluding someone from the full value of his or her contractual claim.

Corporate governance institutions, like shareholder wealth maximization, backed by fiduciary duties, emerged to cabin such opportunistic behavior. Plenary power in managers to alter corporate purpose in ways unauthorized by shareholders is a classic example of the type of problem that corporate law seeks to control. That power will entice rent-seekers to influence managers to divert corporate resources from productive activity toward redistribution.

Employing the corporate form to pursue a collective undertaking should not strip that undertaking of its ends. Yet that is what would happen—indeed, that is the goal—if various stakeholder theories supplant stockholders' goals. This is true whether managers are required or merely allowed to pursue nonshareholder ESG goals.

Corporate law's default rules can be seen as embodying a set of bargains. Relevant for present purposes are (1) the bargains between shareholders and managers and (2) the bargains between shareholders, *via their firms*, and other constituencies.

The bargain between stockholders and managers gives managers substantial discretion in how to run the firms under their charge. They are protected by the business judgment rule, which shields managers from liability as long as they act in good faith and with reasonable care.[24] In parallel, managers must adhere to the fiduciary duties of care and loyalty, which together require them to make best efforts to run the firm for stockholder benefit. This combination arose organically in the 19th and 20th centuries as ownership increasingly separated from control: Shareholders would not

tie their assets up in a firm if managers could use their investment to serve nonshareholder interests; managers would not work for a firm if they had to guarantee optimal returns.

The bargains between corporations and some other constituencies are more explicit. Employees, customers, vendors, and other input providers enter into contracts with clear terms. So, too, do bondholders and certain other capital providers. Although no contract can cover every contingency, repeat experience has caused such contracts to embody the most salient terms between the parties. On the whole, these contracts can be expected to provide benefits to the various input providers that are proportionate to the value they provide.

Each constituency, including managers and shareholders, would be pleased to obtain more from the firm than their bargains allow, but fiduciary duties curb managers' ability to give in to rent-seeking pressures. Traditional corporate law thus offers the greatest opportunity for maximizing total productivity.

But ESG frees managers from fiduciary-duty constraints by creating an acute multiple-masters problem. As summarized by Judge Frank Easterbrook and Professor Daniel Fischel, "a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other."[25] Managers have effectively been freed from any enforceable demand by the various constituencies. Everyone else, however, is now faced with the uncertainty of not knowing whether managers will provide them with the benefits of their bargains.

Although managers can attempt to balance interests in a way that creates the most overall benefit to all firm constituencies, they have demonstrated their willingness to "balance" in favor of the constituencies with interests that are most aligned with their own, or even directly in favor of themselves.[26] And it may be difficult to tell the difference, as managers might be willing to bestow outsized bonuses or contract terms in return for a side payment or something else of personal value to management. By providing cover for managers to seek their own ends—directly or indirectly—at the expense of stockholder benefit, ESG neuters fiduciary-duty constraints.

It is difficult enough to enforce managers' adherence to their fiduciary duties under the business judgment rule. It is a daunting task when obviously self-serving conduct can survive judicial scrutiny by reference to another constituency. It is impossible when managers are free or required to consider constituencies with contractual interests that are directly

adverse to those of the firm, like delinquent vendors or communities with whom tax deals are sought, or even constituencies with no previous connection to the corporation.

Worse, managers who deploy firm resources away from their most productive uses harm overall value production. That ultimately hurts all corporate constituencies—who may get smaller bonuses, sell fewer products, etc.—and the broader society. Corporate law institutions, then, provide benefit well beyond stockholders; ESG, on the other hand, harms society by excluding shareholders from their claims to corporate surplus.

Destruction of Social Value

By breaking down corporate institutions, ESG also impedes efficient production by the corporation. Both the general availability of the corporate form and corporations' activities generate substantial direct and indirect public benefits, many of which are foregone under stakeholder capitalism.

Society benefits from a shareholder-wealth-maximization rule because it constrains managers from overpaying for inputs. It is a basic economic intuition that when production factors are paid the fair value of their production, their inputs are directed to users who will use the inputs in producing the most valuable goods. Paying fair value also ensures that efficient producers are the most competitive. Inefficient resource (broadly understood to include everything from natural resources to human capital) users that can survive only by receiving an inflated price will be unable to survive in the long run. Stated differently, paying fair—rather than ESG-inflated—value for inputs ensures efficient production. Stated yet another way, the corporation facilitates efficient transacting by parties who meet at the corporate nexus. Rent-seeking is wasteful.

It needs little explanation that nonshareholder constituencies also benefit from the pursuit of wealth. Returning to Adam Smith, it is obvious that a business that makes better products will make more money.[27] Its customers will be happier and buy more of its products and will tell friends and family to do the same. Strong sales require more production, creating job security, better raises, and more incentive compensation. More production raises demand for inputs of all kinds, benefiting the providers of those inputs. Owners of labor, land, and capital, along with entrepreneurs, will all benefit from more productive corporations. Corporate creditors will be more secure. Communities will enjoy greater employment opportunities and tax bases.

As the late Professor Lynn Stout, a strong opponent of shareholder wealth maximization, has said:

> [F]or most of the twentieth century, public companies drove the U.S. economy, producing innovative products for consumers, attractive employment opportunities for workers, tax revenues for governments, and impressive investment returns for shareholders and other investors. Corporations were the beating heart of a thriving economic system that served both shareholders and America.[28]

Corporations enabled all of this human flourishing when shareholder wealth maximization was axiomatic, before it was questioned as the proper corporate end (and long before "stakeholderism" was a word).[29] As President John F. Kennedy insightfully said, "A rising tide lifts all boats."[30]

Stockholder wealth created by public companies, the most likely to have stakeholder capitalism forced upon them by financial regulators,[31] is shared by nearly every income level. For example, 58 percent of Americans report owning stocks individually via mutual funds or in self-directed retirement accounts.[32] Public and private pension funds are massive stockholders. More than 90 percent of government employees and nearly 70 percent of private workers have access to retirement plans, with participation rates of 89 and 75 percent, respectively.[33] All of this is in addition to the general increase in flourishing as corporations create value in a competitive marketplace.

The opportunity to invest in public companies is both broadly available and broadly opted into, especially for retirement. Retirement accounts exist to secure wealth for retirees. One cannot retire on assurances of good (for whom?) ESG practices. Inhibiting shareholder wealth maximization will make retirees' lives worse and, at least at the margin, require more retirees to be on the government dole. Those at the margin of the economy—those with lower levels of human capital, less education, less training, etc.—will be the ones who will first lose income as corporations' productivity falls. It should go without saying that this is not a desirable outcome; no one should be driven from self-sufficiency to dependence for the sake of *others'* policy whims.

Conclusion

Stakeholder capitalism is being pushed by ideological partisans who have little respect for ownership rights and, perhaps worse, by those who would benefit financially from more exclusionary capital markets. Moreover,

the managerial incentives created by ESG initiatives are likely to hurt all constituencies to the benefit of managers charged with overseeing their implementation. Still further, the ESG movement is poised to create a toxic mix of government and business, the end result of which will be the broad destruction of social value and a decline in human flourishing.

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Endnotes

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30. "A rising tide lifts all the boats and as Arkansas becomes more prosperous so does the United States and as this section declines so does the United States. So I regard this as an investment by the people of the United States in the United States." President John F. Kennedy, Remarks in Heber Springs, Arkansas, at the Dedication of Greers Ferry Dam, October 13, 1963, http://www.presidency.ucsb.edu/ws/index.php?pid=9455 (accessed May 3, 2023).
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