

Understanding shareholder value

By Wayne Visser

Today, many of us are more familiar with shareholder value than subsistence value. Shareholders are an ingenious invention dating back to the creation of the first corporations in the 17th century. Before then, while subsistence value prevailed, business and trade happened mostly at a small and local scale. Merchants tended to self-fund their enterprises, reaching out to their extended family or a wealthy benefactor for funds. The sponsor would normally be an aristocrat – a member of the political elite who owned land and made their money from taxing the labour and business of their tenants.

But as Europe's strongest countries began to flex their colonial muscles – most notably Britain, Spain, France, Portugal, Belgium and the Netherlands – there was a need to invest larger sums of money in bigger and riskier ventures. Shareholders became a way to pool the financial resources of lots of individuals, who in return could reap the windfalls of the business, should there be any. For instance, they may fund a ship and crew to sail to the other side of the world, discover 'new' lands, and trade for spices and gold.

This is when the first corporations were conceived, so-called charter companies like the Dutch East India Company (VOC) established in 1602 and Hudson Bay Company in 1670. In retrospect, we can be highly critical of these economic agents of colonialism, especially their exploitation of labour and wholesale plunder of the natural wealth of many countries. Unsavoury practices, from war and slavery to racism and even genocide, were par for the course. But moral crimes aside, as an economic institutional invention, corporations were an ingenious way to fund such risky ventures in new territories.

Bear in mind that sending trading ships or colonial settlers to far-flung lands was, in those days, fraught with uncertainty and more likely than not to end in failure and fatality. In fact, from 1690 to 1698, 80 percent of corporations went bankrupt. And then, for more than a century, most corporations were banned in terms of The Bubble Act of 1720, which was only repealed in 1825. In terms of this Act, only corporations granted a royal charter could operate. This was a way for the British government to try to control competition with its own South Sea Company.

Nevertheless, as the Industrial Revolution got going, through the 1700s and 1800s, and as America began to rise, the same legal structure that had worked for colonial conquest was seen as a useful way to create large scale public infrastructure at home, such as railways and water utilities. As Joel Bakan reminds us in his classic critique, *The Corporation*, those original corporations were more like public companies.[i] Their licenses to operate were only granted if they could demonstrate a clear social benefit,

and these rights were usually temporary. What's more, all shareholders could be held liable in the event of bankruptcy.

This all changed when limited liability was introduced in the UK in 1855 and when the restrictions on the purpose, duration, location and ability to own another company's stock were lifted in the US in the 1890s. So began the age of shareholder value and the fiduciary duty of business managers to give primacy to shareholder interests. This legal requirement became an ideological foundation of neoliberal economics, as epitomised by US economist Milton Friedman's 1970 article for the *New York Times* entitled "The social responsibility of business is to increase its profits." [ii]

Friedman's interpretation went on to become the extremely influential dogma of shareholder primacy, so we would do well to understand what he was really saying. The simple argument is that managers work for the owners of the business, who are typically the shareholders or capital providers. Friedman held that any contributions towards social responsibility by those corporate executives would in effect be "spending someone else's money for a general social interest." He goes on to assert: "Insofar as his actions in accord with his 'social responsibility' reduce returns to stock holders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money."

It is worth noting that Friedman does not forbid companies from ever spending money to improve the welfare of employees or communities. Rather, he concedes that

"it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects. Or it may be that, given the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favor by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes."

In any of these instances, Friedman believes that alignment with shareholder value makes these actions justifiable. But then, he says, do not use the "cloak of social responsibility." This is an early version of the so-called "business case for social responsibility," the idea that what's good for society is good for business. The difference with the shareholder value doctrine is that it suggests that companies and their managers should only do something that's good for society when it is simultaneously and demonstrably good for business. And since the wealth of shareholders are taken as a proxy for what's good for business, by implication, we are talking about short-term financial value creation.

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[i] Bakan, J. (2004). *The corporation: The pathological pursuit of profit and power*. Toronto: Viking Canada.

[ii] Friedman, M. (1970). The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13, 122-126.

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