Schumpeter | Capitalism for the people

What if the unwashed masses got to vote on companies' strategies?

ANGLO-SAXON capitalism has had a bad decade. It is accused of stoking inequality and financial instability. A relentless pursuit of shareholder value has led big firms to act in ways that often seem to make the world a worse place. Aeroplane seats get smaller, energy firms pollute the air, multinationals outsource jobs and Silicon Valley firms avoid tax. Some people think that governments should exert more control over private enterprise. But what if the answer to a deficit of corporate legitimacy was to give shareholders even more—not less—power?

That is the intriguing possibility raised by a new paper by Oliver Hart of Harvard University and Luigi Zingales of the University of Chicago. Their argument has two parts. First, the concept of shareholder capitalism should be expanded, so that firms seek to maximise shareholders' welfare, not just their wealth. Second, technology might allow firms to make a deeper effort to discover what their true owners want. Over 100m Americans invest in the stockmarket, either directly or through funds. It is their money at stake, but their views and values are often ignored.

Not long ago mass participation in the stockmarket was held to be an essential part of a healthy market economy—for ordinary people to back capitalism, the argument went, lots of them had to have a direct stake. In the 1960s, individuals directly owned over 80% of American shares and over 50% of British ones. Margaret Thatcher privatised British firms in the 1980s and used TV campaigns to sell shares to the public. Her aim was to bring "ownership, capital and independence" to millions of workers.

Somewhere along the way this dream has been lost. Most peoples' investments are now funnelled through investment managers (individuals directly own only about two-fifths of all shares in America and less than a fifth in Britain). A few giant money managers have a dominant voice. America Inc still has "proxy" votes, where crazy proposals can be made—but these resemble a Potemkin shareholder democracy which is really controlled by technocrats. Asset managers have defined their mission as maximising the market value of their clients' portfolios, and in turn demand that firms maximise profits.

Ever since companies were granted the privilege of limited liability in the 1850s a debate has raged about their obligations to society. In an article published in 1970, Milton Friedman, an economist, made the case that a firm's only duty is to its bottom line. That is not as callous as it sounds. Most shareholders have a mix of financial goals and ethical beliefs. The profit-hungry firm can be part of a system that satisfies both their desires. The company creates profits which can then pay for the "ethical" objectives that a shareholder has: for example, charity donations to help the poor, or taxes to pay for a government-provided safety net.

Unfortunately, as Messrs Hart and Zingales point out, this division of responsibilities does not always work. If a supermarket profits from selling machine guns to the mentally unhinged, for example, there is no action that shareholders can undertake with those profits that can mitigate the ensuing deaths. And if the government is too dysfunctional to produce coherent policies, there may be no way to offset the externalities—massive job cuts in one town, say—that profit-seeking firms create.

So sometimes the only way to maximise shareholders' overall welfare may be for the firm to look beyond profits. The authors argue that some interpretations of American law give boards of directors more room for manoeuvre here than is commonly understood. The next stage is to find out what shareholders want. Technology could help, allowing individuals to vote the shares held on their behalf by pension trustees and investment funds.

The authors envision shareholders guiding the broad direction of company strategy. They do not elaborate on the details, but imagine 100m Americans pressing a "shareholder democracy" app on their phones. Grannies from Grand Rapids and cowboys from Colorado might vote for Delta Air Lines to provide more legroom, Exxon to assume a higher carbon price when it drills for oil, IBM to move some jobs from Delhi to Detroit and Apple to pay a higher tax rate than its current 18%. It would be a plebiscitary shareholder democracy, more in tune with what many Americans think, but more dangerous, too.

There are two big risks. One is that the combined voice of tens of millions of shareholders becomes a meaningless cacophony that no board can deal with. As Andrew Carnegie, the 19th-century Scottish-American tycoon, put it: "Where stock is held by a great number, what is anybody's business is nobody's business." The other pitfall is that shareholders manage to produce a clear enough voice, but that this voice is stupid, fickle or sinister. This is clearly possible, too. Most individuals have little idea about the technicalities of running big companies. In the investment world retail shareholders are often known as "dumb money" because of their tendency to buy high and sell low.

Shareholders' values

Just as political democracy only works with checks and balances, the same is true for shareholder democracy. Messrs Hart and Zingales suggest that for a proposal to be put to a digital vote by all shareholders, it would need the support of at least 5% to start with. Another safety mechanism would be to make the votes of ordinary shareholders non-binding. Boards would have to note them, but would not need to obey. Or people could invest through single-issue funds, which are identical to normal funds except that they guarantee to pursue a well-defined goal—for firms to pay higher wages, for instance, or to cut pollution levels.

Plebiscitary capitalism may seem far-fetched. But the company has evolved continually to deal with pressures that boil up from society over time. More participation by ordinary, individual shareholders might be exactly what capitalism now needs to restore its reputation. ■