A ONE-LEGGED STOOL

HOW SHAREHOLDER PRIMACY HAS BROKEN BUSINESS (AND WHAT WE CAN DO ABOUT IT)

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INTRODUCTION

This is not a book for "businesspeople."

It's a book *about* business for all people because all of us should care deeply about business and how it is conducted.

Why? Business (a.k.a. private enterprise) is today's dominant social institution, much as the church was during the Middle Ages or the monarchy during the Renaissance. Its influence is everywhere, and it affects virtually every aspect of our lives.

As it should.

Business, as a construct, is amazing. It is responsible not only for producing most of the goods and services we need, but also for generating the income to acquire them and the free time to consume them.

That's no small feat, and it's only possible thanks to the embrace of three fundamental forces: utility, specialization, and empowerment.

"Utility" is just an economic synonym for "usefulness": that is, how well a product satisfies a customer's wants or needs. The better it can satisfy a human desire, the more valuable it is and, consequently, the more a person is willing to pay for it.

This basic concept drives all sorts of transactions in our society: most obviously commerce, but also employment (where employees exchange their skills for a paycheck and, hopefully, some personal satisfaction); investing (where individuals buy stock in the expectation of a return on their investment); and communities (where governments offer tax breaks and other incentives to companies in exchange for creating jobs and paying tax revenue).

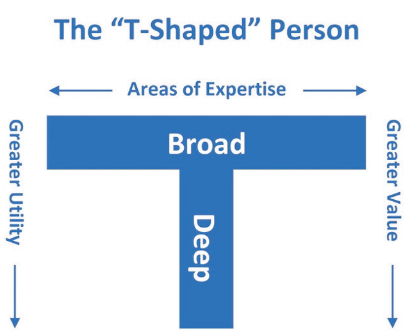
Over time, humanity has been able to steadily increase the utility in all of these transactions. Products, jobs, investments, and communities have all been improved and, as a result, our quality of life has improved.

This progress is due, in large part, to the realization that no one is good at everything.

Some of us are better at math. Others are better at writing. Still others are better at working with computers or making grilled cheese sandwiches or whatever. That's just the way it is.

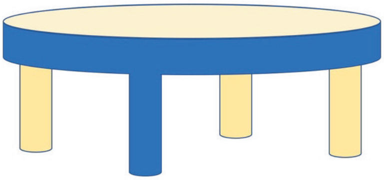
However, this diversity of talent also means each of us has an area where we can be more useful — where we are able to contribute more utility to an effort.

The best visualization of this concept is perhaps the "T-shaped" person, a recruiting metaphor first popularized in the 1990s. This suggests that the ideal employee should have two types of skills: deep expertise in one particular area (represented by the vertical leg in a capital "T"), as well as a broad basic understanding of other related areas and how everything works together (represented by the horizontal bar).



So, success for an enterprise comes from assembling a diverse team of specialists who can work together to elevate the overall effort by applying the increased utility that comes from their individual expertise. The result is a product with greater overall utility and, therefore, greater value.

It's like building a stool where the height of the legs works together to collectively elevate the seat off the floor. The arrangement is good for everyone, with each of the legs helping to support the others. In fact, without this symbiotic connection, individual legs are much more unstable and likely to just fall to the floor.



This holds true not just for teams of employees, but also for the composition of the greater enterprise. Each stakeholder, including employees, customers, investors, and the community, provides specialized utility to the effort and, without any of them, the overall endeavor will have a much more difficult time.

There's just no way around it. Unlocking the benefits of specialization requires interdependency. The only way to elevate one leg is to elevate all of them.

Of course, this type of group effort requires a significant amount of organization and coordination. Historically, this role has been the purview of a centralized clergy, royalty, or bureaucracy, where a select few make decisions for everyone: what people should believe, what they should do for a living, and what products they should produce (and purchase).

Without fail, many of these decisions are poor. People are assigned jobs for which they have no real talent. Products are of lower quality. Overall utility is restricted, and the whole system underperforms for everyone — employees, customers, investors, and communities.

And while you might think that these bad decisions are the result of malice or stupidity, it's more likely they're due to the fact that people are too diverse and our society is too large and complex to be centrally managed. It doesn't matter who's in charge. Any paradigm created by a centralized authority (even with the best of intentions) will inherently oversimplify reality, resulting in solutions that (at best) only work for a few or (at worst) don't work for anyone.

As a structural concept, private enterprise fixes this problem. Due to its decentralized, participant-driven nature, it does a better job of aligning skills as well as wants and needs because it empowers individuals to weigh in on these decisions: that is, to share where they find utility.

- Employees are empowered to choose which careers they want to pursue.
- Consumers are empowered to choose which products work best for them.
- Investors are empowered to choose who they support with their money.
- Citizens are empowered to choose what kind of community they want to live in.

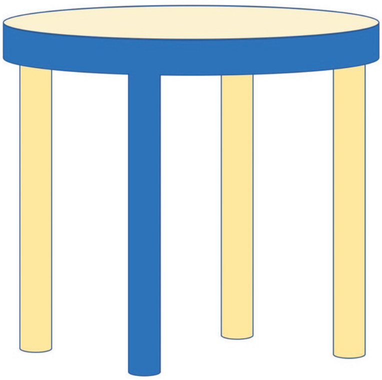
Businesses respond to all of this choice by trying to create solutions that all the stakeholders will find most valuable. It's a collective navigation that ensures business is always steering toward a place where the aggregate finds the most utility.

That's not to say that business is perfect. Far from it. Business, too, isn't at its best on its own. It needs other institutional "legs" (e.g., the government) to help guide and support it.

However, by supercharging specialization with empowerment, business has created an unprecedented increase in utility, which has driven amazing progress for humanity.

Most incredibly, this progress has been sustained for generations, feeding on its own advances in technology. New technology creates the need for more and more specialization which, in turn, leads to more and more utility and more and more value.

In essence, the legs of the stool have continued to get longer, lifting everyone higher and higher.



To date, humanity hasn't discovered a better way to harness the power of working together — aligning the best people with the right roles so that everyone benefits.

Of course, progress isn't always steady. Sometimes other, larger forces, such as recession, war, or even a pandemic, can temporarily slow down the collective rise of the stool.

It was during one of these slowdowns in the 1970s that some people, including Nobel Prize-winning economist Milton Friedman, decided that business needed fixing. Specifically, they felt the dynamic was too complex, with too many competing interests, and that it could be greatly improved with some simplification.

For his part, Friedman believed that businesses should only focus on one thing: maximizing profit for shareholders. In a 1970 article in the *New York Times Magazine*,[1] he laid out his argument that such a singular focus on one type of value (money) and one stakeholder (shareholders) would remove a lot of inefficiency from the whole system.

Sure enough, as this concept of "shareholder primacy" was first getting traction, companies were able to make some easy gains by cutting the fat. But, as anyone who's ever trimmed a steak knows, if you keep cutting, pretty soon you're going to run out of fat and end up cutting meat. And that's exactly what happened.

By the 1980s, finding true inefficiencies had become harder and harder. Yet, shareholders, who had become used to their elevated status and consistent returns on investment, were demanding more.

So, under the paradigm of shareholder primacy, companies did the only thing they could: They turned the knife to the meat, extracting value from other stakeholders (including employees, customers, and communities) in order to keep paying shareholders their higher rate of return.

To put it another way, businesses started lengthening one leg of the stool at the expense of others.

This, of course, is really bad for the stool. And for business. Elevating shareholders above all other stakeholders reflects a short-sighted shift to "I-shaped" thinking, ignoring the interdependency and equilibrium that makes business so productive and beneficial in the first place.

The crazy thing is that most business leaders know this favoritism is harmful, yet they keep "maximizing shareholder value" anyway.

Indeed, a 2006 survey of corporate financial officers found that 80% would cut vital expenses such as marketing or product development in order to make quarterly earnings targets, even though they knew it would most likely hurt long-term corporate performance.[2]

Why?

Perhaps it is the simplicity of only having to please one constituency (investors) rather than having to balance multiple, competing interests.

Maybe it's that dealing with dollars and other numbers is easier than measuring more subjective criteria such as preferences and emotions.

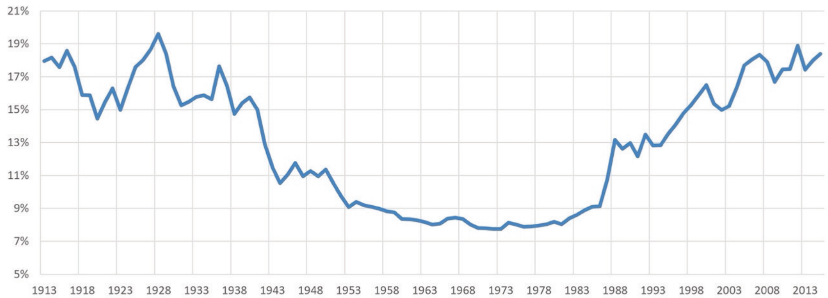
It could also be that the bulk of executive compensation is now tied to share price rather than a salary, aligning the interests of corporate leaders with shareholders.

Or, it could be that shareholder primacy has been the "gold standard" of corporate behavior for decades now and is so deeply ingrained in our thinking that executives don't feel they even have a choice — that it's just the way things are.

Whatever the reason (or reasons), 50 years of tilting the stool of business has increasingly destabilized it, creating or exacerbating a host of problems in our society.

Favoring investors (who, by definition, have money to spare) has significantly contributed to the increase in economic inequality, where the rich have gotten richer and the poor have gotten poorer. Since 1967, the top 20% of Americans increased their share of all income from 43.6% to 51.2% (a relative increase of 17.4%). During the same time period, the bottom 20% saw their share of income drop from four percent to just 3.1% (a relative decrease of 22.5%).[3]

In fact, the top one percent of Americans today account for a staggering 18.39% of all income, a concentration not seen since the Roaring Twenties, right before the Great Depression.[4]



Share of all income earned by the top one percent of Americans. (Source: "The Chartbook of Economic Inequality," Atkinson, Hasell, Morelli, and Roser, University of Oxford, 2017)

This level of disparity inherently breeds class tension, eroding the belief that "all men are created equal" while increasing the distrust and polarization that come from an "us versus them" mentality. Unfortunately, this toxic atmosphere only reinforces itself, spiraling us further down, and eroding the civility and cooperation on which society depends.

That's not to mention the impact that shareholder primacy has on our natural environment. This shared resource is often harvested or destroyed for the disproportionate benefit of stockholders.

Throughout this discord, business smiles reassuringly and tells all the stakeholders that they're important. It has to because it needs all of the legs to keep the stool standing. Of course, telling each of us we're equally valued while acting in a way that clearly demonstrates we're not creates cognitive dissonance and massive distrust of business, which make the stool even more unstable.

And while most of us recognize these issues and their relation to business, we tend to accept them as an unavoidable consequence of private enterprise. Like business leaders, we believe that shareholder primacy is just the way it is and there's nothing we can (or should) do about it.

But shareholder primacy hasn't always defined business. Before the 1970s, the dominant theory was called "managerialism," a belief that business leaders were "stewards or trustees charged with guiding a vital social and economic institution in the interests of a wide range of beneficiaries."[5] It not only sounds nice, but it also worked. From 1930 to 1970, managerialism oversaw the rise of the U.S. as an economic superpower, flourishing innovation, rising employee wages, and a steady stream of dividend checks for shareholders. (In fact, the S&P 500 returned a compound average annual return of 7.5% during this time frame.[6])

So maybe it's time to actually notice what we blindly accept. To question the unquestionable. And to see if there's a better way forward.

That's what this book aims to do.

It examines the entire dynamic of shareholder primacy, starting with something most of us have personally experienced: mistrust of business. Following those feelings to their source, it diagnoses who (or what) is to blame for our current situation, including some questionable assumptions that underpin today's system of private enterprise.

Next, it reviews the broader context of business, how we got here, and how the same forces that used to be beneficial have become so destructive.

Finally, it offers an alternative. A simple, straightforward approach that can stabilize the stool of business, repairing it so it once again elevates all of us, including shareholders.

The simple fact is we need business. It is the only institution with enough resources — accounting for almost 90% of U.S. Gross Domestic Product (GDP)[7] — to solve the massive societal and environmental problems we face today.

But as long as shareholder primacy reigns, we don't stand a chance. A one-legged stool *will* fall over. It's just a matter of time.

NOTES

Introduction

1. Milton Friedman, "The Social Responsibility of Business Is to Increase its Profits," *The New York Times Magazine*, September 13, 1970.
2. Lynn A. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (San Francisco: Berrett-Koehler Publishers, Inc., 2012), 67, Kindle.
3. Atkinson, Hasell, Morelli, and Roser, "The Chartbook of Economic Inequality," (2017), https://www.chartbookofeconomicinequality.com/inequality-by-country/usa/.
4. Ibid.
5. Lynn A. Stout, "On the Rise of Shareholder Primacy, Signs of Its Fall, and the Return of Managerialism (in the Closet)" (2013), Cornell Law Faculty Publications, Paper 865, 1171.
6. Ibid.
7. U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Output by Industry," revised June 24, 2021, www.bea.gov.