Stakeholder Theory as a Basis for Capitalism: A Reply to My Economist and Philosopher Friends

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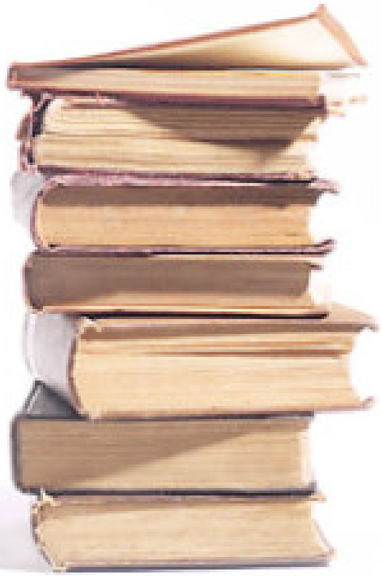


Outline

- Some Mechanics of Stakeholder Theory
- The Friedman Problem
- The Jensen Move
- The Williamson Result
- Entrepreneurship Theory
- So What?

Some Mechanics of Stakeholder Theory

- The Separation Fallacy
- The Integration Thesis
- The Responsibility Principle
- The Open Question Argument

The Separation Fallacy

- It is no longer useful to believe that sentences like, "x is a business decision" have no ethical content, or any implicit ethical point of view.
- It is no longer useful to believe that sentences like "x is an ethical decision, the best thing to do all things considered" have no content or implicit view about value creation and trade (business).

The Integration Thesis

- Most business decisions, or sentences about business have some ethical content, or implicit ethical view.
- Most ethical decisions, or sentences about ethics have some business content or implicit view about business.
- One of the most pressing challenges facing business, ethics, and society scholars (and business executives) is to put business and ethics together.

The Integration Thesis: A Different Way to Say It

1. It makes no sense to talk about business without talking about ethics.
2. It makes no sense to talk about ethics without talking about business.
3. It makes no sense to talk about business or ethics without talking about human beings.

The Responsibility Principle

- Most people, most of the time, want to and do accept responsibility for the effects of their actions on others.
- The Responsibility Principle is incompatible with the Separation Fallacy.
- Ethics doesn't get off the ground with some version of the Responsibility Principle.

The Open Question Argument

- If this decision is made for whom is value created and destroyed?
- Who is harmed and/or benefited by this decision?
- Whose rights are enabled and whose values are realized by this decision (and whose are not)?
- Since these questions can always be asked, we need to give up the separation fallacy once and for all.

The Genesis of Stakeholder Theory

- Integration Thesis (Denial of Separation Fallacy = Open Question Argument) + Responsibility Principle = Stakeholder Theory
- Businesses and executives (and stakeholders, Wicks, et al) are responsible for the effects of their actions on precisely those groups and individuals that they can affect, and be affected by.
- For most businesses, at a minimum, are responsible for the effects of their actions on customers, employees, suppliers, communities, and financiers.
- "Responsibility" is a non trivial idea.

The Friedman Problem

- Maximize shareholder value vs. create value for stakeholders.
- The only obligation of executives is to maximize profits vs. executives have a responsibility for the effects of their actions on stakeholders.

The Friedman Problem

- What does it mean to maximize profits?
- It may mean having:
  - (1) Kick-ass products and services that customers want and that do what you say they do.
  - (2) Suppliers who want to make you better and who stand behind what they do.
  - (3) Employees who are inspired by what you stand for and who show up ready to be engaged.
  - (4) Being a good citizen in communities that want you to be there.
  - (5) Making a lot of money for financiers.

The Real Friedman Problem

- Difference about the way the world works.
- Difference about what the theory is about.
- Stakeholder theory isn't about social responsibility. It is about CSR: Corporate Stakeholder Responsibility
- So is Business.
- Economics is about something else.

The Jensen Move

- Replace Max Shareholder Value with “Enlightened Value Maximization” = Sum of all values of all financial claims on the firm.
- Issue #1: “Purposeful Behavior Requires the Existence of a Single-Valued Objective Function”
- Issue #2: “Total Firm Value Maximization Makes Society Better Off”.

The Jensen Move

- Neither claim is very useful.
- What Jensen is really worried about is "self-dealing" and "bad faith".
- Is self dealing worse among "shareholder-oriented firms" than among "stakeholder oriented firms"? Is "Total Value" any better here?

Jensen's Final Position: EVM + Enlightened Stakeholder Theory

- "We can learn from the stakeholder theorists how to lead managers and participants in an organization to think more generally and creatively about how the organization's policies treat all important constituencies of the firm. This includes not just financial markets, but employees, customers, suppliers, the community in which the organization exists, and so on." (245)
- If tradeoffs have to be made, then choose that course of action which maximizes total value.

Some Questions for Jensen

- EVM seems the right theory of finance.
- Can we find a surrogate for total value that takes into account the value created for customers, suppliers, employees and communities?
- One Proposal: Stake Options.

The Williamson Result

- Echoes Simon's idea that it is important to understand "the nature of human beings whose behavior we are studying".
- Bounded Rationality
- Opportunism
- Organizations are governance mechanisms.

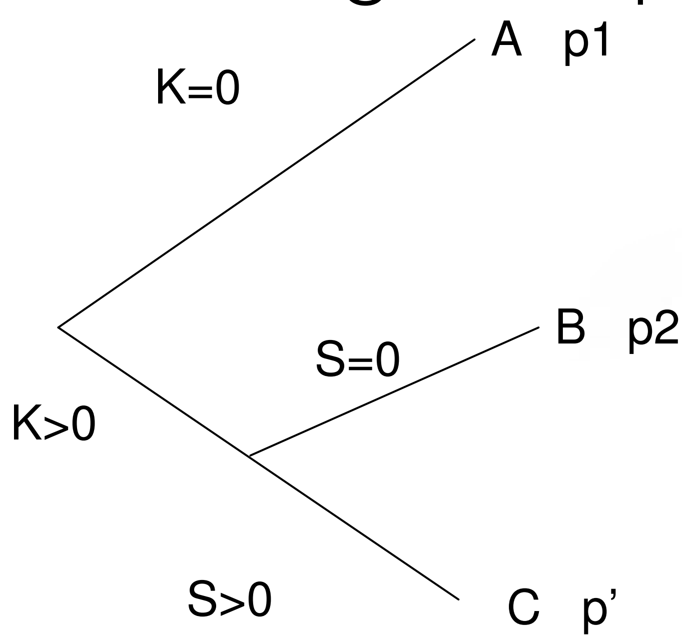
The Williamson Result

- The most effective governance mechanisms are made through bilateral contracting, which most stakeholders engage in. These contracts have safeguards.
- Financiers need an "endogenous" governance mechanism like Boards of Directors.
- "Boards of Overseers" may be a good idea to reduce information asymmetry for other stakeholders.

The Williamson Result

K =transactions cost

S=safeguards; p=price



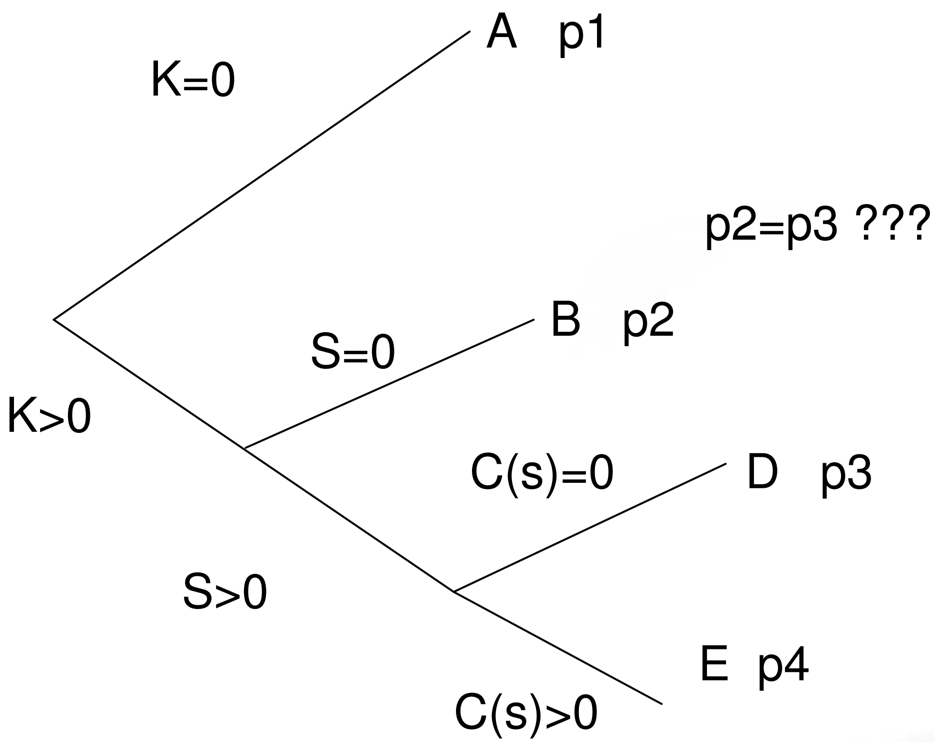
Some Important Amendments

- Safeguards have costs
- Call safeguards, at node E, "endogenous" if the costs of the safeguards are borne by the parties to the contract.
- Call safeguards, at node D, "exogenous" if the costs of the safeguards are borne by outside parties such as the state.

The Williamson Result

K =transactions cost

S=safeguards; p=price



Some Important Amendments

- By Williamson's own assumptions, each party has the incentive to find exogenous safeguards, and by employing a "careful comparative institutional approach" we indeed find that to be true.
- Exogenous safeguards for financiers:
  - Markets for finance, like the market for shares, and bonds.
  - SEC
  - Intermediaries
  - Mechanisms set up by SARBOX

Some Important Amendments

- Any shareholder can avail themselves of the exogenous safeguards, and almost costlessly redeploy its assets. Shareholders have little asset specificity.
- Not true for large shareholders.
- Boards of Overseers will never arise as long as stakeholders can use exogenous safeguards.

Some Important Amendments

- Who really bears asset specificity, and should sit on Boards? Maybe the answer is some heavily invested stakeholders who cannot costlessly redeploy and who have few exogenous safeguards.
- Difficult to see how this could be controversial.

Some Questions for Williamson

- Can we think about Boards of Directors whose tasks are to:
  1. Reduce information asymmetry among key stakeholders so that management could more easily create even more value;
  2. View the interests of financiers, customers, suppliers, communities and employees as joint.
  3. Assume the continuation of the corporation through time.

– If these are "boards of overseers" instead of boards of directors, does it really matter.

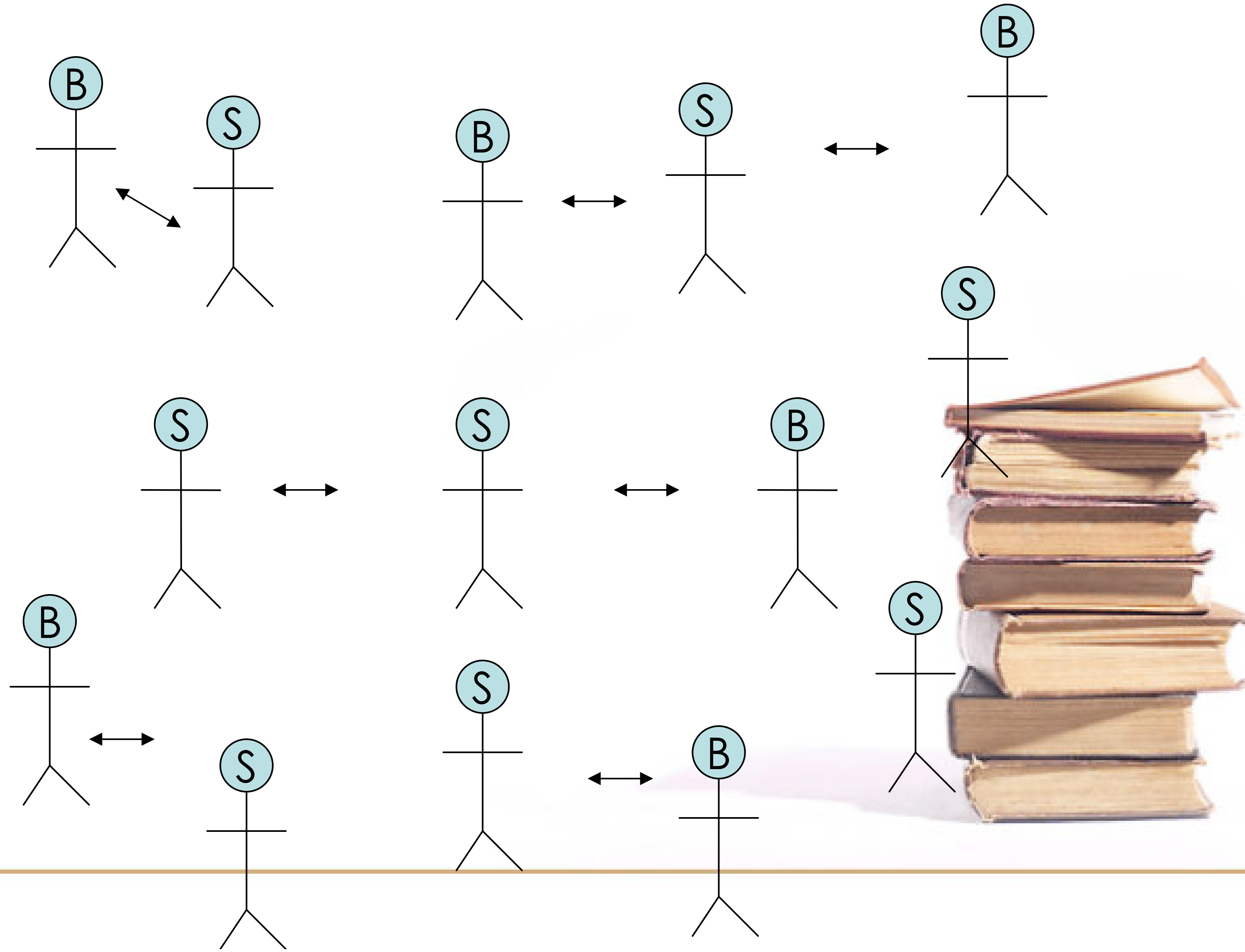
Back to Miles: So What?

- Even economists have come around to stakeholder thinking.
  - Conclusion: Battle over.
- Even philosophers put their arguments in stakeholder terms while decrying the diminished role for traditional ethical theory.
  - Conclusion: Battle over, or not worth fighting—just walk away.
- Declaration of victory: war is over. Stakeholder theory is becoming the main way we think about value creation and trade

Where We Need to Work

- Value Creation and trade:
  - Go back to basics
  - How is value creation and trade sustainable over time?
  - Can we give an account that is at once descriptive, aspirational and normative, and managerial?

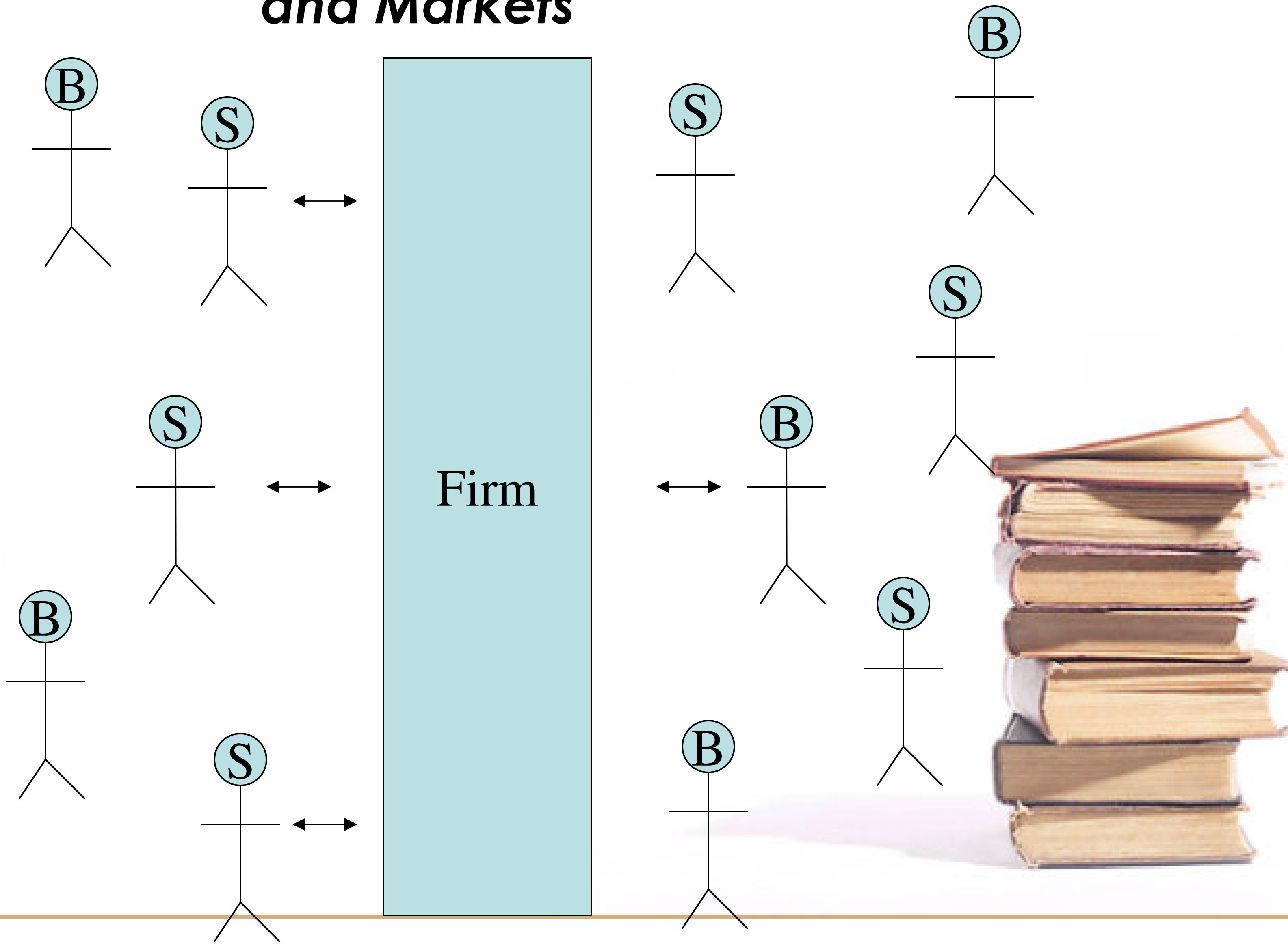
The Standard Account of Value Creation and Trade



Features of the Standard Account

- There are buyers and sellers.
- Market conditions (numbers of buyers and sellers) and information reflected in prices, determine how value is distributed.
- Buyers and Sellers are “black boxes”.
- Not much insight into entrepreneurial process.

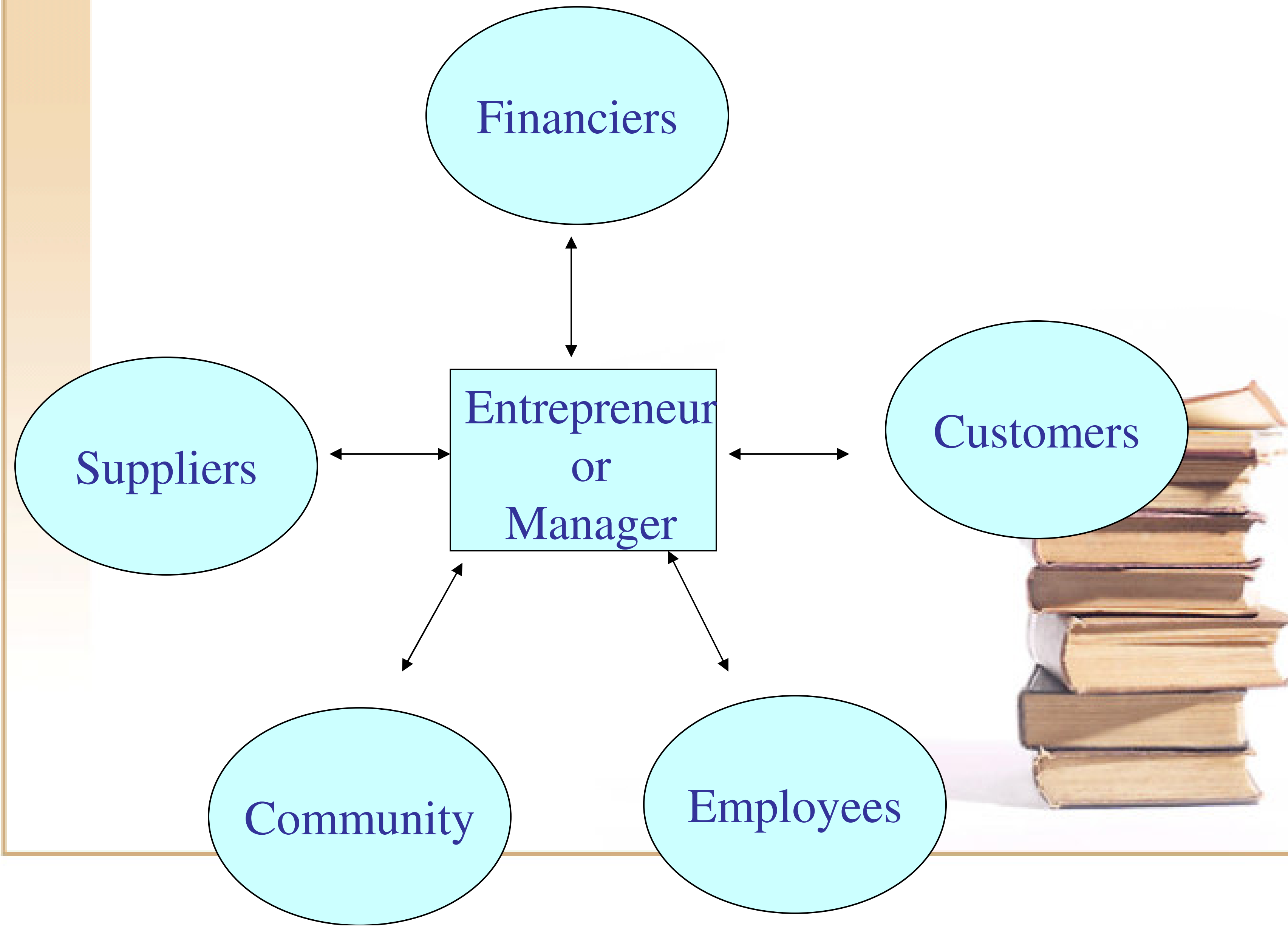
The Emergence of Hierarchies and Markets



Features of Markets and Hierarchies View

- Using the pricing mechanism has a cost, so sometimes it is easier to organize transactions via authority rather than markets.
- Understanding "transactions costs" is the critical variable.
- Why does value get created in firms?—Because markets are more costly in the real world sometimes.
- How does value get created? –Not much insight here.

The Stakeholder View of Value Creation and Trade



Features of the Stakeholder View

- The entrepreneur or manager puts together a deal that simultaneously satisfies multiple stakeholders.
- Each stakeholder is important for the deal to be sustainable.
- Other stakeholder relationships may well be important in so far as they influence the primary ones.

Two Principles of Equilibration

- Weak force allows stakeholder by stakeholder renegotiation.
- Strong force ensures the possibility of new deals.

The Principle of Stakeholder Cooperation

Value can be created, traded, and sustained because stakeholders can jointly satisfy their needs and desires by making voluntary agreements with each other, that for the most part are kept.

The Principle of Stakeholder Responsibility

Value can be created, traded, and sustained because parties to an agreement are willing to accept responsibility for the consequences of their actions. When third parties are harmed, they must be compensated, or a new agreement must be negotiated with all of those parties who are affected.

The Principle of Complexity

Value can be created, traded, and sustained because human beings are complex psychological creatures capable of acting from many different values and points of view.

Where We Need to Work

- What kinds of theories of responsibility can we develop that have sophisticated understandings of the way that value creation and trade works, and what kind of creatures we really are and can be?
- Are there more robust theories of human beings to be developed for business, that do not depend on "The Great Jackass Fallacy"?

Where We Need to Work

- Is there a matrix of relevant ethical concepts that can be combined with our understanding of business, such as:
  - Responsibility-Freedom-Authenticity
  - Autonomy-Solidarity-Relationships
  - Individuality-Community