Resetting Capitalism

Luigi Zingales

University of Chicago

September 2021

- Today capitalism is corporate capitalism
- If we want to reset capitalism, we need to rethink the way corporations are run.
- Starting from the famous Friedman's doctrine


INDEX SUNDAY, SEPTEMBER 13, 1970 PAGE 379 OF

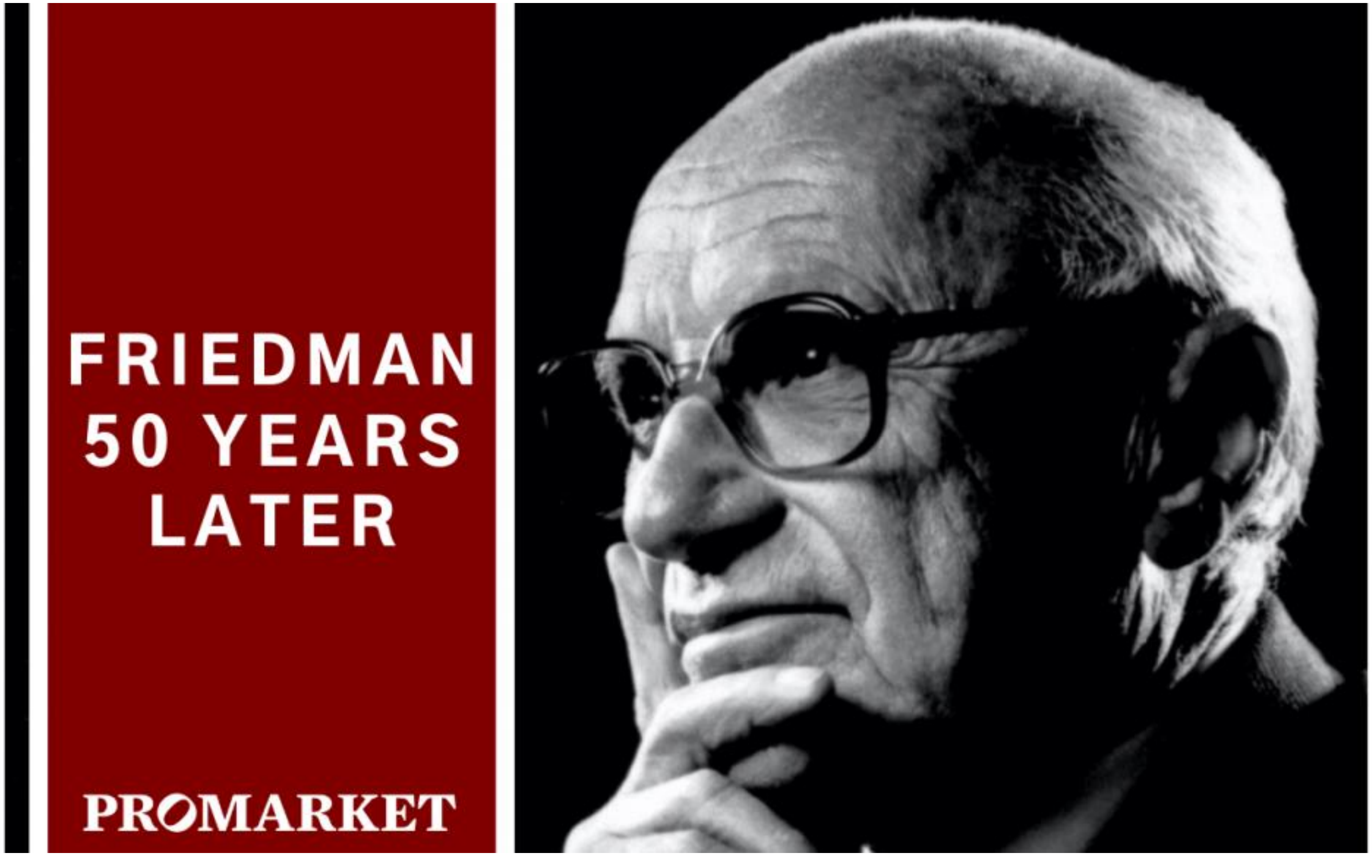
A Friedman doctrine—

The Social Responsibility Of Business Is to Increase Its Profits

By MILTON FRIEDMAN

TAMING G.M.—Chairman James Roche of General Motors (right) replies to members of Campaign G.M. (below, wearing "Tame G.M." buttons) at the corporation's stockholders' meeting in May. Representatives of the campaign demanded that G.M. name three new directors to represent "the public interest" and set up a committee to study the company's performance in such areas of public concern as safety and pollution. The stockholders defeated the proposals overwhelmingly, but management, apparently in response to the second demand, recently named five directors to a "public-policy committee." The author calls such drives for social responsibility in business "pure and unadulterated socialism," adding: "Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society."

- Love it or hate it, Milton Friedman's piece in the NYT 50 years ago shaped the conversation and capitalism for the last 50 years
- To what extent his ideas are still valid today,
- To what extent are not,
- How should we modify them if we want to reset capitalism



Friedman Separation Theorem

- Under the assumptions that

1. Companies are price (and rule) takers (competitive market)
2. No externalities (or government perfectly able of address them)
3. Agents only care about monetary payoff
4. Complete contracts

=> Maximizing (long term) shareholders' value lead to a Pareto optimal equilibrium.

What is new?

- Any well trained economists will recognize that this is nothing more than a restatement of the celebrated First Welfare Theorem
- Formally proved only in 1951
- Friedman writes for a general audience
- He makes a simpler argument:

1. In a free economy, stakeholders voluntarily get together and assign the residual right to shareholders
2. Imposing any additional burden on them is taxation without representation

Are these assumptions true?

4. Contracts complete?

- Contracts are clearly incomplete
- Thus, even if markets are perfectly competitive ex-ante, they might not be competitive ex-post after a specific investment is made

$\Rightarrow$Shareholders are not the only residual claimants

  - Think about employees

- It might be optimal to protect other stakeholders from expropriation

- If this risk is so large, why stakeholders do not contract differently?
- Why vast majority of corporations assign votes only to shareholders?
- Why codetermination is imposed, not chosen?
- eBay vs Newmark (2010)

“Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.”

- Is the evolutionary argument necessarily right?
- No, we can have

1. Bounded rationality
2. Initial wealth constraints
3. Limits in the law
    - But now there is the benefit corporation

- Not the strongest point of attack

3. **Individuals care only about monetary returns**

- This is false

a. Proof by example

b. Donations

c. Endowments

- Even if it does not hold, Friedman claims that it is still better for shareholders to maximize their profits and then donate their dividends to the desired cause
- Is it true in general?

Where Friedman Is Wrong

- Hart and Zingales (2017) show that if it is cheaper not to pollute than to pollute and clean up, then it is more efficient for companies to adopt shareholders' social objectives such as protecting the environment.

$\Rightarrow$corporate boards should maximize <u>shareholder welfare</u> (not value)

- This opens complicated social choice issues

2. Externalities

- These are large (pollution, risk, community, etc.)
- When shareholders were locally based, it was easier to internalize these externalities.
- Today it is very difficult and legislation is trying to make it even more difficult
- Conservatives claim that government regulation, not corporations, should address these externalities
- But they are the very same people against regulation
- It would be easier for the government to regulate, if the companies did not lobby against (a point I will return momentarily)

- Can these externalities be resolved by the private sector?
- Broccardo, Hart, and Zingales (2020) show that if the majority of investors are even slightly altruistic and if they are well diversified => then allowing them to vote will force companies to internalize the externalities
- Under Trump the DOL was trying to limit this by prohibiting asset manager to consider any other factor except the financial return
- The reaction is so strong because this method has the potential to be effective

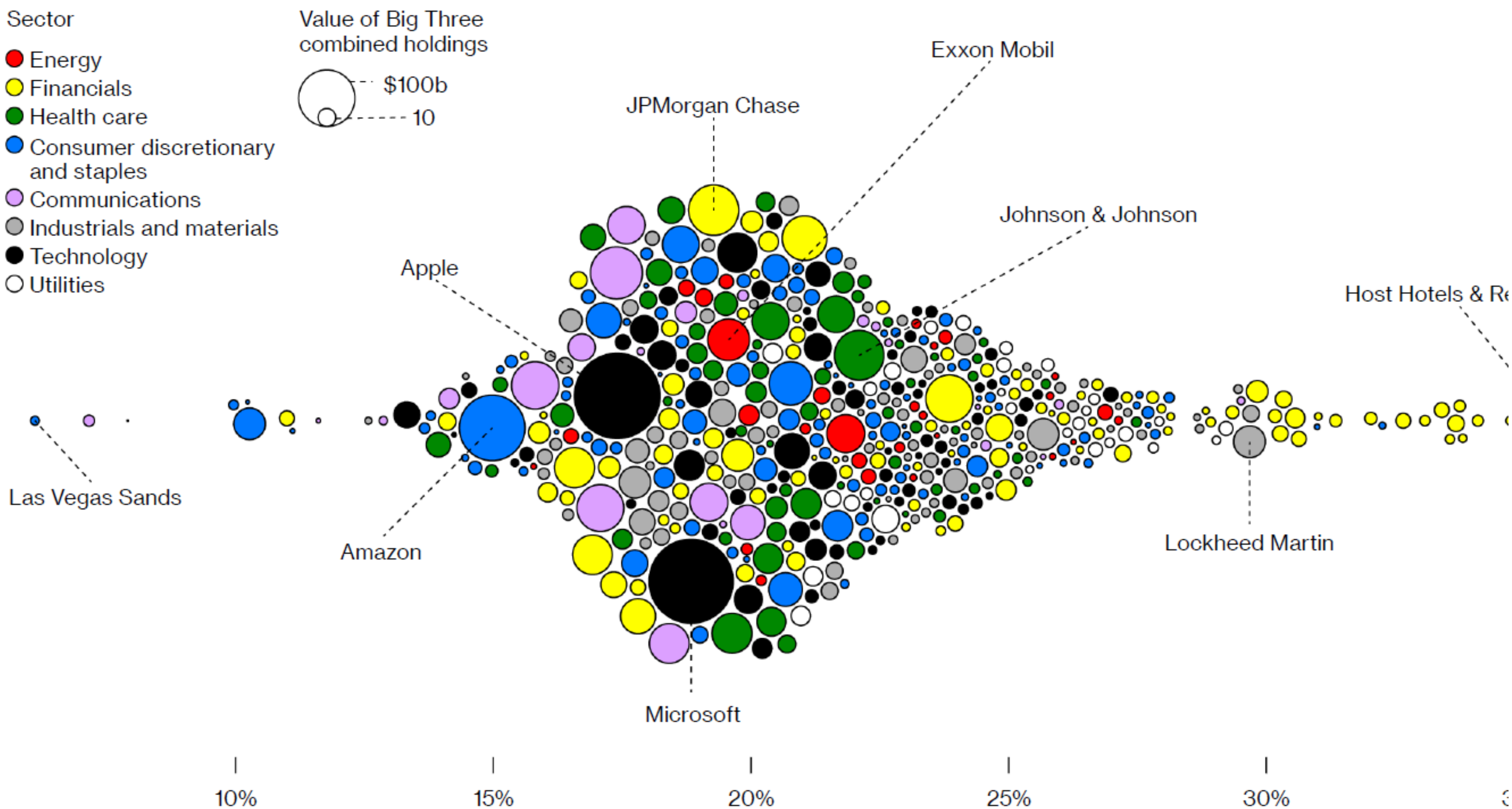
1.A Price Takers

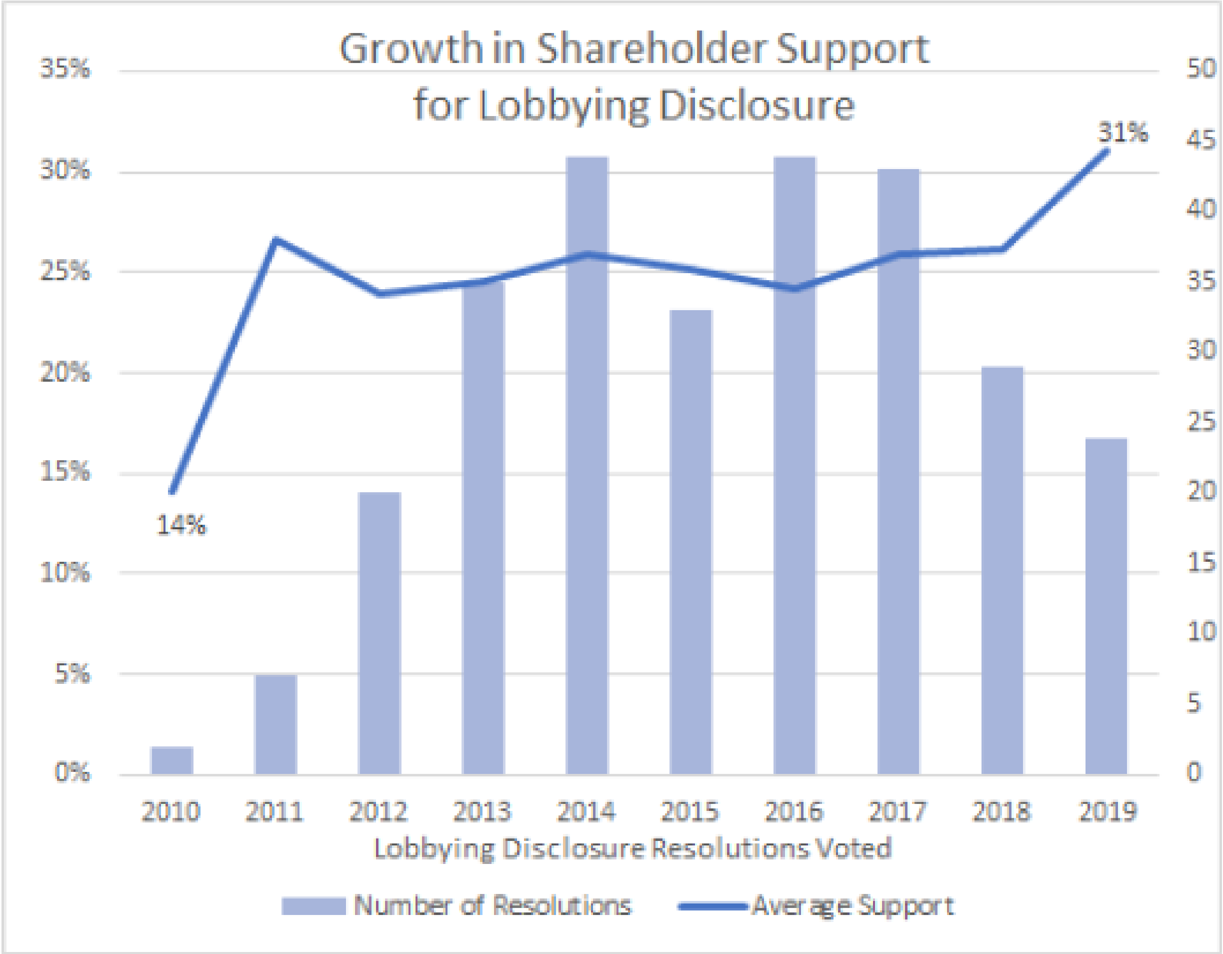
- Even Friedman agreed that monopolies should not maximize profits
- He simply believed that monopolies did not exist without a government protection
- But what about Google?
- Is the Social Responsibility of Google to maximize profits?
- How to prevent it from happening
  1. Nationalization
  2. Regulation
  3. Different Fiduciary Duty?

- **1.B Rule Takers**
- Corporations should "make as much money as possible **while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom**" Friedman (1970)
- Yet, in 1971 Stigler recognized that corporations captures the regulators and shape regulation
- Thus, the rules are not exogenous: they are endogenous.
- Is the social responsibility of a CEO to lobby Congress to be free of polluting?
- Obviously not.
- This is where Friedman rules is untenable
- How to constrain companies on this front?

The Big Three's Stake in Corporate America

As investors pile into index funds, BlackRock, Vanguard, and State Street have become the leading shareholders in many public companies. With combined ownership ranging from 35.5% at Host Hotels & Resorts to 6.1% at Las Vegas Sands, on average the Big Three own 22% of the typical S&P 500 company.





Source: Morningstar Proxy Voting Database.

Implications

- I would divide the world in two:
  1. If you are a <u>small corporation</u>
     - You have no market power
     - You are subjected to regulation
     - You cannot change the rules of the game

⇒Friedman's principle (modulo Hart and Zingales, 2017) works

  2. Very <u>large corporation</u>
  - You are likely to enjoy market power
  - You are too big to fail and too big to jail
  - You can easily change the rules of the game

=> Friedman principle does not apply

- How do you define large?
- Yet in the financial industry the regulation for systemically impotent financial institution works a bit like that.
- But here you would need to impose a fiduciary duty towards society
- The Board is personally responsible (for a multiple of the directors' fee received) if the company opportunistically exploits externalities
- It needs the evidence of having exercised a duty of care in this sense.

If you want to learn more, subscribe to my podcast