The Economist

Schumpeter

Businesses can and will adapt to the age of populism

How executives balance shareholder expectations and social pressures

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AS THEY slid down the streets of Davos this week, many executives will have felt a question gnawing in their guts. Who matters most: shareholders or the people? Around the world a revolt seems under way. A growing cohort—perhaps a majority—of citizens want corporations to be cuddlier, invest more at home, pay higher taxes and wages and employ more people, and are voting for politicians who say they will make all that happen. Yet according to law and convention in most rich countries, firms are run in the interest of shareholders, who usually want companies to use every legal means to maximise their profits.

Naive executives fear that they cannot reconcile these two impulses. Should they fire staff, trim costs and expand abroad—and face the wrath of Donald Trump's Twitter feed, the disgust of their children and the risk that they'll be the first against the wall when the revolution comes? Or do they bend to popular opinion and allow profits to fall, inviting the danger that, in the run up to their 2018 annual general meeting, a fund manager from, say, Fidelity or Capital will topple them for underperformance?

Wiser executives know that shareholder value comes in shades of grey. It has been a century since the idea was baked into American law. In 1919 a court ruled that "a business corporation is organised and carried on primarily for the profit of the stockholders." In the 1990s this view spread to Europe, Asia and Latin America because of reforms to governance laws and the rising clout of institutional investors. But the doctrine is not monolithic. Schumpeter reckons there are six distinct corporate tribes, each with its own interpretation of what shareholder value means. Firms have some flexibility to choose which one they belong to.

Start at the far right of the spectrum, with the corporate fundamentalists. Boosting their profits and share price—immediately—is their goal. Firms built on these objectives rarely do well for long. Valeant, a Canadian pharmaceutical concern, is an example. In 2011-15 it raised prices, slashed investment, paid little tax and fired staff. By 2016 it faced scandals and its shares fell by 85%. Occasionally firms become so weak that they use fundamentalist tactics, temporarily, to try to restore confidence. IBM is shoring up its stock price with savage cost cuts and share buy-backs.

Shift a little to the left and there are the corporate toilers. Most Western firms place themselves in this group. They believe in the primacy of shareholder value but are prepared to be more patient. At their best these firms are consistently successful—think of Shell or Intel investing on a ten-year time horizon.

Corporate oracles, the third group, want to maximise profits within the law, but with a twist. They think the law will evolve with public opinion and so they voluntarily do things today that they may be required to do tomorrow. Most energy firms have become greener to anticipate changing public expectations on pollution and safety. Laggards discover it can be devastating when the rules of capitalism change. Shares of coal and nuclear-energy firms in the rich world have collapsed. Soft-drinks firms may be next, as attitudes and laws about sugar and obesity change.

Corporate kings are in a luxurious position. They are so successful at creating shareholder value that they have a licence to ignore it periodically. In July Jamie Dimon, the boss of JPMorgan Chase, now the world's most valuable bank, gave its lowest-paid staff a pay rise, "because it enables more people to begin to share in the rewards of economic growth". Paul Polman describes Unilever, the consumer-goods firm he runs, as a non-governmental organisation committed to cutting poverty. He can do so only because Unilever makes a stonking return on equity (ROE) of 34%.

Outside Western boardrooms, the most common sect is the fifth, corporate socialists. These firms are controlled by the state, families or dominant managers. They think that shareholder value is not as important as social objectives such as employment, high pay or cheap products. But they recognise that institutional investors have some legal powers. So profits are set according to an informal quota system—outside shareholders should get the minimum required to avoid a revolt, but no more. China's state firms together book an ROE of 6-8%. Goldman Sachs is a corporate champagne socialist. It pays its shareholders the least it can get away with and allocates what is left as bonuses for its staff.

On the far left are the corporate apostates. They are organised in a corporate form but don't care about shareholders at all. Usually this is a result of political dysfunction. PDVSA, Venezuela's state oil firm, pays for much of the country's welfare state and cronyism. Fannie Mae and Freddie Mac, two state-owned American mortgage firms, are run to make cheap loans, not profits.

Sects change

Between 1990 and 2007 companies around the world drifted right, towards shareholders. Now in response to populism they may drift back. But don't expect a governance crisis. The system is adaptable. Carmakers are shifting factories to America; drugs and defence firms may slash prices. All have become oracles. They anticipate that the Trump administration will change rules on tariffs and government procurement that govern their businesses. Shareholders can object only so much. Firms become corporate socialists if they have controlling owners who demand they prioritise social objectives. There is no sign of this yet.

Many individual firms will still move the other way, towards shareholders. Google is becoming a corporate toiler, not a king, as its growth slows. After its emissions scandal, Volkswagen is dropping its extravagant ways and firing staff. Under its new boss, Tata Group in India will now start to worry about profits as much as nation-building. And in order to revive the economy, Japan's firms will need to drive their ROE above the present, sluggish 8%. In the contest between shareholders and the people, companies and bosses are caught in the middle. But there are no final victories. Just constant, pragmatic accommodations.

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