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Executive Summary

The purpose of privately owned businesses has been an increasingly important issue confronting executives and members of corporate boards since Friedman's iconic 1970 essay that argued that the purpose of private businesses is to maximize profits, which equates to producing and distributing their products as efficiently as possible. Perhaps the most prominent challenge to Friedman's argument is the claim that a narrow focus on benefiting shareholders is inconsistent with benefiting society more broadly. Critics of Friedman's *shareholder* model of corporate governance propose that administrators of companies implement a *stakeholder* model. The stakeholder model of corporate governance prioritizes the interests of a range of different economic agents including consumers, employees, suppliers, local communities in which companies are located, and the physical environment in addition to shareholders.

The practical relevance of the stakeholder model has been questioned on the grounds that a profit-maximizing business will act in the interests of important stakeholders anyway, particularly consumers and employees, because it is profitable to do so. A business that ignores the interests of its customers will lose sales to companies that promote their consumers' welfare, while a business that "underpays" or otherwise takes advantage of its employees will find it more difficult to hire competent employees compared to rivals who offer competitive compensation packages and related conditions of employment. In this context, the stakeholder model is a relevant challenge to the shareholder model only if business behaviour

> "Mandatory ESG mandates distort managerial efficiency and exacerbate principal-agent problems between management and shareholders."

differs between the two models. Specifically, the models differ in their relevance only if promoting the interests of non-shareholders comes at the expense of shareholders.

Obviously, if the stakeholder model of governance is inconsistent with economic efficiency, it is possible that other stakeholders besides shareholders will fare worse under the stakeholder model of governance than they would under the shareholder model. Most obviously, a decline in efficiency implies that consumers will be charged higher prices and employees will earn less compensation. Suppliers will be paid less for their inputs, and communities will realize lower business tax revenues. In short, an argument can be made that many stakeholders would be better off if companies maintained the "traditional" shareholder model of corporate governance.

Bebchuk and Tallarita (2020a; 2020b) make a case for why the stakeholder model of corporate governance is inferior to the shareholder model from the perspective of overall social welfare. The reason is that senior executives and corporate board members are more likely to implement strategies and actions that benefit themselves at the expense of shareholders and other stakeholders. This is because it is more difficult for stakeholders to monitor the performance of executives and board members when the latter operate with broad, possibly conflicting, and difficult-to-measure objectives, as well as because the incentives to monitor the performance of executives and board members are weaker when there is a large number of principals whose interests are at stake. The potential for principal-agent conflict (i.e., a situation in which a company's management prioritizes its own pecuniary and non-pecuniary interests over the interests of shareholders) is relevant even when the shareholder governance principle guides corporate actions. In this context, Bebchuk and Tallarita's main contribution is their extension of the problem that principals have in ensuring that their agents act in their interest to the stakeholder governance model.

Proponents of the stakeholder model of corporate governance argue that adopting the model will promote corporate actions that address social pathologies such as climate change, discrimination, and income inequality. Conversely, Bebchuk and Tallarita argue that stakeholder governance will displace laws and regulations which are more effective instruments to address broad environmental and social issues. In this regard, Bebchuk and Tallarita's objection to stakeholder governance is similar to Friedman's admonition that private sector executives should not be expected to assume the roles of politicians in a democratic society.

While there is no direct evidence bearing upon the issues that Bebchuk and Tallarita discuss, there is some evidence from the performance of mixed enterprises suggesting that expanding the mandate of corporate executives to include environmental and social objectives is likely to produce the worst of all possible worlds. Mixed enterprises are organizations in which there is both public (government) and private ownership. As such, mixed enterprises are meant to focus on achieving social goals such as reducing unemployment, while also making profits for their private owners. In fact, evidence suggests that mixed enterprises are less profitable that their privately owned counterparts, while they are also less likely to achieve targeted social benefits compared to their non-profit counterparts.

> "Evidence suggests that mixed enterprises are less profitable that their privately owned counterparts, while they are also less likely to achieve targeted social benefits compared to their non-profit counterparts."

This and other indirect evidence suggests that the interests of society are more likely to be promoted by the wealth created by efficient businesses operating under a shareholder governance model than by mandating or otherwise pressuring companies to pursue environmental and social goals within a stakeholder governance framework. Increased wealth provides the financial and technological means to help address environmental and other social objectives.

Introduction

The past few decades have witnessed increasing demands on the part of prominent investment managers, academics, and environmental and consumer activists, among others, for senior executives and corporate board members to adopt one or another so-called stakeholder model in place of the traditional shareholder model.[1] The stakeholder model of corporate governance obliges senior managers and board members (henceforth referred to as administrators) to prioritize the interests of groups beyond shareholders in their corporate decision-making. In effect, under the stakeholder model, shareholders are only one of several constituencies whose interests should be considered by administrators in the latter's decision-making. Besides shareholders, stakeholders can include consumers, employees, suppliers, the larger communities in which organizations do business and, for many proponents of stakeholder governance, the natural environment. The stakeholder model of corporate governance can be seen as an evolutionary rebuttal of Friedman's (1970) iconic defense of the traditional shareholder model, which holds that long-run profit-maximization should be the sole objective of corporate administrators operating in a manner that adheres to broadly applicable legal and regulatory frameworks established by the state.

A recent specific focus of the ongoing debate surrounding whether the stakeholder model should be the dominant principle underlying corporate governance encompasses the ability of administrators to implement some version of the stakeholder model and whether the wider interest of society is best served by administrators adopting the stakeholder principle of corporate governance. Obviously, the latter issue supersedes the former issue, since if adopting the stakeholder model is not in the broad public interest, it then follows that

administrators should not adopt that model as the guiding principle of corporate governance. However, even if the stakeholder model is in some conceptually relevant ways a superior principle to guide administrative decision-making, it is irrelevant as a practical guide if administrators cannot operationalize it efficiently. Indeed, there has been an active recent debate surrounding the legal and practical constraints on administrators prioritizing a stakeholder model over a shareholder model. [2]

The main focus of this essay is on the feasibility of operationalizing a stakeholder model of corporate governance, as well as the plausible consequences of prioritizing the interests of stakeholders other than shareholders as the main principle of corporate governance. An important question raised by the latter consideration is whether the interests of stakeholders are better served by administrators pursuing a shareholder model of corporate governance rather than a stakeholder model.

The essay proceeds as follows. The next section summarizes the main arguments put forward by US scholars Lucian Bebchuk and Roberto Tallarita against the adoption by administrators of a stakeholder model of corporate governance. While several of Bebchuk and Tallarita's arguments are rooted in Friedman's original defense of shareholder governance, the recent debate surrounding the practical challenges to implementing a stakeholder governance model has primarily centred on Bebchuk and Tallarita's criticisms of alternatives to shareholder governance. The third section presents the main rebuttals to Bebchuck and Tallarita's analysis. Section four offers an assessment of the arguments for and against shareholder governance. Concluding comments are provided in the final section.

Bebchuk and Tallarita's critique of the stakeholder model

Before discussing Bebchuk and Tallarita's critique of the stakeholder model of corporate governance, it is useful to outline the main features of that model. As noted above, the core premise of the model is that there are other important stakeholders besides shareholders whose interests administrators should take into account when they set and implement corporate strategy and associated corporate activities. Two broad justifications have been offered in support of this expansive governance principle. The first is that incorporating the interests of stakeholders other than shareholders into administrative decision-making will enhance the long-run profitability of for-profit companies. The second and more nuanced justification is that stakeholder governance is socially desirable, even at the cost of reduced long-run returns to shareholders, to the extent that stakeholder governance helps address broad social problems such as climate change and income inequality.

Bebchuk and Tallarita (2020a; 2020b) dismiss the first justification as an "enlightened shareholder value" version of the stakeholder model. They argue that such an instrumental version of "stakeholderism" is not conceptually different from shareholder primacy, a point made by Friedman (1970) and others.[3] Any difference between the shareholder governance model and the stakeholder governance model is purely semantic, and therefore no good reason exists for administrators to adopt the stakeholder governance model.

With respect to the second justification, Bebchuk and Tallarita implicitly agree with Friedman's (1970) caution against having unelected private-sector administrators making broad social policy decisions. Specifically, they argue that incorporating the welfare of individual stakeholder constituencies into a business organization's objective function will inevitably oblige administrators to make tradeoffs, whereby some stakeholders will benefit at the expense of others. Making such tradeoffs, in turn, requires administrators to identify the relevant set of stakeholders and assign weights to the relative importance of the various stakeholders and their interests in order to make tradeoffs in a manner that increases the overall social welfare created by their administrative decisions. For example, a decision to substitute clean energy sources for carbon fuels will reduce an organization's carbon emissions and contribute in a very small way to ameliorating climate change. However, it is likely that the organization's costs will increase, with these higher costs passed on to consumers of the organization's products in the form of higher prices. An informed evaluation of this tradeoff would require administrators to assign relative values to their organization's contribution to mitigating climate change and to the associated economic harm to consumers. The tradeoff becomes even more complex if other stakeholders are involved. In this regard, it is likely that shareholders will be affected by the organization's higher costs of producing output, as will employees and other input suppliers if the organization's scale of operations or its competitive position within its industry is affected by its fuel use selection.

> **"(Bebchuk and Tallarita) argue that incorporating the welfare of individual stakeholder constituencies into a business organization's objective function will inevitably oblige administrators to make tradeoffs, whereby some stakeholders will benefit at the expense of others."**

The ubiquitous nature of ongoing tradeoffs across various constituency groups and societal objectives under the stakeholder governance model obliges unelected private sector administrators to make complex and perhaps controversial judgment calls. Bebchuk and Tallarita question whether corporate administrators are competent to make such judgment calls.[4] More specifically, they argue that the comparative advantage in formulating and implementing public policy resides with regulators and politicians. In this regard, Bebchuk and Tallarita (2020a) acknowledge and accept that corporate activities can have adverse effects on stakeholders and cite environmental harms as an example. They go on to argue that their preference for addressing such harms through government laws and regulations reflects their belief that laws and regulations are more effective and appropriate instruments for dealing with potentially adverse environmental and social consequences of business activity, as opposed to relying on the judgment calls of private-sector administrators.[5]

As will be discussed in more detail in the next section of this essay, a criticism of Bebchuk and Tallarita's defense of the shareholder model is that it too readily dismisses the ability of administrators to identify and prioritize the interests of different stakeholders. Another criticism is that their defense ignores the existential imperative for administrators to adopt a stakeholder model of governance because if they do not do so, the public may increasingly question the rationale for private ownership of businesses.[6] As a practical defence of the shareholder model, Bebchuk and Tallarita cite legal constraints on administrators that oblige them as fiduciary agents for shareholders to act in the interests of shareholders. They also argue that the compensation that administrators receive typically is closely tied to the financial performance of their organizations. Hence, changes in both the legal environment regarding the responsibilities of administrators and the structure of administrators' compensation would need to be implemented to facilitate the adoption of the stakeholder model.

If we accept for the moment that the legal environment surrounding corporate governance can be modified so that administrators face no potential legal liabilities for implementing stakeholder governance, the issue of particular relevance is how administrative behaviour would change if administrators operated under a stakeholder model rather than a shareholder model of corporate governance.[7] Bebchuk and Tallarita (2020a; 2020b) argue that the incentives for administrators to act opportunistically would increase significantly if shareholder governance was replaced by stakeholder governance. In this context, acting opportunistically means that administrators would use more of the organization's resources for their own benefit rather than for the benefit of stakeholders, including shareholders, than would otherwise be the case. Such behaviour could take the form of using corporate resources for perquisites such as personal travel, transportation, and entertainment, hiring friends and family members as employees or consultants, and simply taking more leisure time and devoting less time and energy to work.

There are two main reasons to expect more opportunistic behaviour on the part of administrators operating under a stakeholder governance model. One is that it is much more difficult to structure an effective compensation scheme for administrators when the objectives of the organization are ill-defined and difficult to measure than when they are clearly defined and readily measurable.[8] A second reason is that there will be less effective monitoring of the behaviour and performance of administrators the larger and more diffuse the set of principals in whose interests the administrators are presumably acting, since the benefits to any subset of principals from engaging in monitoring are dispersed among a much larger group of principals. This condition encourages free-riding in monitoring administrators.

Increased opportunism on the part of administrators applied across many business organizations almost certainly will translate to slower productivity growth in the private sector. This, in turn, means lower profits and likely higher prices for consumers and lower wages for employees. It also means lower tax revenues for governments, with concomitant fiscal pressure to reduce the growth of government spending on social programs. In this context, and following the logic of Bebchuk and Tallarita's analysis, a stakeholder model threatens to compromise the welfare not just of shareholders but of virtually all of society.

Criticisms of Bebchuk and Tallarita's arguments

Prominent academics and practicing legal experts have criticized the arguments against the stakeholder governance model as discussed in the preceding section. It is relevant to note that just as some of Bebchuk and Tallarita's arguments in favour of shareholder governance overlap those made by Friedman, so too some of the criticisms of Bebchuk and Tallarita's analysis overlap earlier rejections of the shareholder governance model.

Perhaps the most directly relevant criticism is the rejection of the Bebchuk/Tallarita argument that adopting the stakeholder model will encourage opportunism on the part of administrators and therefore will promote inefficiency with widespread social costs. Mayer (2022) claims that an increasing percentage of institutional and retail investors want the companies they invest in to pursue environmental, social and governance (ESG) objectives, as is implicit in the stakeholder governance model. While he acknowledges that this obliges directors and asset managers to monitor corporate performance and to make judgments about corporate initiatives to promote ESG priorities, he argues that they are capable of doing so, as long as companies have clearly stated corporate purposes, e.g., to reduce their carbon emissions by a given amount over a given period of time.

Mayer further argues that even though the outcomes of many ESG initiatives cannot be quantified in a standardized format that permits aggregation, e.g., units of a currency, non-monetary costs and benefits can be measured "in their own terms." While he does not spell out this notion precisely, Mayer suggests that corporate directors can make meaningful value judgments regarding corporate actions just as individuals facing personal tradeoffs can. Underlying the capability of directors to evaluate the decisions of senior management is a clear statement of the corporation's social purpose and explicit ESG-related objectives.[9]

Savitt and Kovvali (2022) dismiss concerns about directors acting opportunistically even if given the opportunity. They characterize Bebchuk and Tallarita as imagining that directors, freed from the shackles of share-price maximization, will engage in a frenzy of self-interested behaviour, ordering corporate affairs to their own benefit without regard to corporate purpose or corporate value. They assert that no one who has actually advised a corporate board would give credence to this characterization of board members' behaviour. Rather, they maintain that the majority of directors are "decent and careful," and that norms matter to them. Moreover, if directors fail to perform their oversight function effectively, they can be voted out of their positions by shareholders and even sued. Savitt and Kovvali therefore highlight what is perhaps the main focus of the debate about corporate governance that Bebchuk and Tallarita raise. Namely, is the accountability of administrators significantly compromised if companies adopt the stakeholder governance model? This issue will be discussed more fully in the next section of the essay.

Savitt and Kovvali also reject the argument that environmental and social policy issues are appropriately in the decision-making domain of legislators and regulators, not corporate administrators.[10] They assert that external regulation of business and adherence to the shareholder governance model has been a failure, as evidenced by a worsening climate crisis and a burgeoning crisis of income inequality among other social pathologies. At a minimum, they argue, the widespread adoption of the stakeholder governance model will not render external regulation any less effective than it has been in the recent past—contrary to Bebchuk and Tallarita's views—although they stop short of arguing that private sector administrators will be more efficient and effective in addressing environmental and social issues than politicians and regulators have been.[11] They do assert that the public is increasingly exasperated by public officials who seem unable or unwilling to "step in," and so citizens are now demanding "better performance" from the corporations they interact with. Hence, they argue, the failure of companies to discard the shareholder governance model will therefore undermine public trust in the private sector, which over time poses an existential risk for capitalist enterprises.

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In summary, it should be emphasized that Bebchuk and Tallarita's critics do not argue that shareholder interests should be devalued under the stakeholder model, although how shareholders' interests remain uncompromised when the stakeholder model is implemented is usually not clearly explained. Savitt and Kovvali suggest that a commitment to stakeholders helps a company connect more deeply to its customers and enables it to adjust to the changing demands of society—which ultimately has an important bearing on long-term corporate profitability. However, this is merely a version of the enlightened shareholder value argument for the stakeholder model. A more nuanced version of this argument is that the shareholder model encourages a focus on short-run profit maximization at the expense of long-run value maximization. This focus benefits administrators at the expense of shareholders who, for reasons not made clear by proponents of the stakeholder model, are supposedly unable or unwilling to hold administrators to account for sacrificing long-run wealth maximization in order to drive up share prices in the short run and thereby boost executive compensation tied to stock options and the like.[12]

Mayer (2022), among many others, accepts that shareholders are likely to suffer some financial penalty if companies abandon the shareholder model in favour of the stakeholder model. However, he argues that many shareholders are willing to accept a financial penalty in exchange for the companies in which they invest promoting broader social purposes beyond profit-maximization. The growth of the ESG-investing phenomenon suggests that a significant percentage of private investors seems willing to have their administrators follow a stakeholder governance model, although it is less clear that those investors are expecting and accepting of lower risk-adjusted financial returns by doing so.[13] If investors are so inclined and capital markets are relatively efficient, the lower risk-adjusted returns should be offset by so-called psychic returns, i.e., the psychological satisfaction of contributing financially to environmental and social causes. However, this is not a sufficient defense of adopting the stakeholder model since individual shareholders can make direct financial contributions to non-profit organizations and other worthy causes using the returns they make on their investments.[14] It is certainly possible that the foregone profits associated with departing from a shareholder model mean less rather than more financial surplus is available for environmental and social initiatives.[15]

In summary, Bebchuk and Tallarita's critics are compelled to address the issue of whether the effectiveness of administrators in serving the interests of ESG-oriented shareholders, as well as other stakeholders, will diminish significantly when their organizations switch from shareholder to stakeholder governance models. In particular, the "good" social outcomes that ESG-oriented shareholders might be seeking may not be realized if administrators appropriate or otherwise dissipate the returns that should have gone to shareholders and other stakeholders.[16] This concern returns the analysis to Bebchuk's and Tallarita's focus on the incentives and capabilities of administrators to act opportunistically, and whether these incentives and capabilities are conditioned by the choice of corporate governance model.

Determinants of opportunism and indirect evidence

As discussed in an earlier section of this essay, there are at least two prominent reasons to expect that moving from a shareholder to a stakeholder model will exacerbate principal-agent conflicts in companies, in this case conflicts between different groups of stakeholders, including shareholders, and administrators. One is that the proliferation of performance criteria will make it more difficult for shareholders and other stakeholders (i.e., principals)

to monitor the actual performance of administrators (i.e., agents), especially when the additional (to profitability) criteria are difficult to quantify. A second reason is that expanding the set of principals who prioritize different performance criteria, as will be the case when moving to a stakeholder model, is likely to reduce the incentives of stakeholders to monitor the performance of administrators. These two phenomena underlie the conceptual relevance of Bebchuk and Tallarita's criticism of the stakeholder governance model. However, the practical relevance of their criticism is ultimately an empirical issue.

Some insight into the empirical relevance of their criticism of stakeholder governance can be drawn from studies of the financial performances of companies that are relatively highly rated for their ESG performance compared to their less highly rated counterparts. While it is possible that the highly rated companies have found ways to monetize their ESG initiatives and are therefore still profit-maximizing, it might also be the case that highly rated ESG-oriented companies are more likely to have adopted a stakeholder model. The latter assumption, combined with an anticipated more problematic principal-agent relationship, leads to a prediction that highly rated companies on ESG metrics will have significantly lower financial returns compared to less highly rated companies.

Globerman (2022c) reviews the literature on returns to ESG investing and concludes that the available evidence shows no consistent relationship between a company's ESG alignment and the returns on equity, holding constant other factors influencing returns on equity shareholdings. This general finding is not direct evidence that stakeholder governance contributes to reduced firm-level economic efficiency and hence lower profitability because of administrative opportunism, as one would expect to see a consistent negative relationship between ESG rankings and returns to equity to be consistent with the Bebchuk and Tallarita argument. However, this evidence does cast doubt on the validity of the enlightened shareholder defence of the stakeholder model.[17]

The performance of "mixed enterprises," which are organizations in which government and private investors share ownership, provides indirect evidence bearing on the relationship between the stakeholder model and corporate governance. The mixed ownership model can be likened to the stakeholder model of corporate governance, inasmuch as government investors presumably have objectives different from those of private investors and take equity shares in organizations in order to promote strategies and actions that would not otherwise be implemented if the organizations were entirely privately owned. A finding that mixed enterprises perform less efficiently than enterprises that are entirely privately owned and presumably pursuing a shareholder model of governance would be consistent with Bebchuk and Tallarita's basic argument.

Boardman and Vining (1991) provide a comprehensive analysis of the behaviour and performance of mixed enterprises. They note that the outcomes are different depending upon factors such as the degree of public versus private ownership and the extent of concentration or dispersion of private shareholdings. The degree of competition in the enterprises' main lines of business also influences their performance, holding ownership structure constant. They conclude that different ownership structures affect the extent to which mixed enterprises engage in profit maximization, socio-political goal maximization, or managerial utility maximization (i.e., administrator opportunism). Ownership structure also affects the degree of conflict between one owner and another, and between an owner and management. Overall, they assess both theory and evidence as suggesting that mixed enterprises do not achieve socio-political objectives nor attain the efficiency of private enterprises. In effect, mixed enterprises are the worst of both worlds. This overall finding is consistent with Bebchuk and Tallarita's concern about multiple objectives and disparate stakeholders compromising corporate governance, with associated adverse economic outcomes for shareholders and arguably unsatisfactory outcomes for a broader set of stakeholders.

Yet another stream of literature provides some insight into the behaviour of organizations that do not have relatively narrow and well-defined objectives and where management is not accountable to a single group of stakeholders with the power to reward and punish management based on the latter's performance. Specifically, Chant and Acheson (1972) and Acheson and Chant (1973) draw on the theory of public choice, and specifically the theory of bureaucratic behaviour, to analyze central bank monetary policy. At the time they wrote their articles, the legislation governing central banks typically provided a wide-ranging mandate with multiple, vaguely defined goals. While price stability was almost always one of those goals, it was not a well-specified goal, and its ranking relative to other goals was not necessarily clear, making decision-making difficult and accountability problematic.

Acheson and Chant argued that the vagueness surrounding the objectives of monetary policy and the opaqueness of central bank behaviour suited central bank officials who were empowered by these conditions to maintain their status and their organizational resources by evading public scrutiny and accountability. The ambiguity surrounding central bank objectives and the opaqueness of their behaviour was also consistent with the interests of central bank administrators given that central bankers were unsure that they could readily achieve any clearly specified set of objectives with the tools they had at hand.

In a more recent contribution, Schembri and Globerman (2023, forthcoming) link opaqueness and weak accountability surrounding monetary policy to the rapid inflation and above-average unemployment (stagflation) during the 1970s and 1980s, which, in turn, triggered widespread public dissatisfaction with the performance of central banks. Public pressure for improved macroeconomic performance led to the adoption of specific and explicit inflation targets. At the same time, central banks were accorded independence from governments to achieve and maintain those targets. Schembri and Globerman conclude that the adoption of explicit numerical inflation targets and related governance and transparency reforms worked well to lower inflation from the much higher rates of the 1970s and 1980s and helped keep inflation low and stable for the subsequent three decades prior to the Covid-19 pandemic.

What central bank history suggests is that the nature of an organization's governance affects the behaviour of administrators and the performance of their organizations. In particular, it suggests that ambiguous organizational objectives weaken the accountability of administrators to the organization's stakeholders, which benefits the former and harms the latter. This experience supports Bebchuk and Tallarita's concern that the adoption of broad stakeholder governance models by for-profit companies will harm the interests of shareholders without necessarily benefiting, and indeed possibly even harming, the interests of other stakeholders.

Concluding comments

There is a lengthy academic literature discussing how the separation of ownership from management in large publicly traded companies creates conditions under which managers can pursue their own personal objectives and interests rather than creating wealth for shareholders.[18] Indeed, some critics of Bebchuk and Tallarita's position on stakeholder governance point to the diverse interests of the shareholders of large public companies as presenting a similar challenge as the stakeholder model to the principal-agent relationship.[19] However, rather than acknowledging that the principal-agent relationship will face yet additional challenges by expanding the scope of the competing objectives of greater numbers of stakeholders, Mayer (2022) and others argue that, if directors can be relied upon to hold managers accountable to shareholders, they can also be relied upon to hold management accountable to a larger and more diverse set of stakeholders.

While theory and evidence suggest that organizations will become less efficient and therefore less profitable when moving from a shareholder to a stakeholder governance model because of increased administrator opportunism and a focus on multiple objectives, no meaningful public policy concerns are raised as long as shareholders are knowledgeable and can sell their investments in less profitable companies in order to reinvest in more profitable companies.[20] Under such circumstances, it can be presumed that investors in organizations explicitly pursuing ESG initiatives under stakeholder governance principles have interests beyond maximizing the risk-adjusted rates of return on their investments. As such, legislation prohibiting fiduciaries from making investments in companies that publicly disclose their commitments to ESG initiatives will reduce the span of assets available to investors, which would make capital markets less efficient, other things constant.[21]

By the same token, legislation and regulations that directly or indirectly oblige companies to substitute stakeholder governance for shareholder governance also limit the set of assets available to investors and make capital markets less efficient. To the extent that a substantial number of investors want to "do well by doing good" and favour companies operating according to a stakeholder model, the favoured companies will enjoy equity price premia and lower financing costs, thereby enabling them to invest and grow relative to companies that do not adopt a stakeholder governance framework. If it turns out that administrator opportunism makes doing good too costly for investors, companies operating under a shareholder model will attract financial capital, thus enabling them to grow relative to companies operating under a stakeholder model.[22] In short, investors can express their corporate governance preferences in capital markets, which renders moot the issue of whether regulators should mandate the adoption of stakeholder governance.

To be sure, Bebchuk and Tallarita's critics are not primarily concerned about capital market efficiency. Those critics who claim they are defenders of capitalism assert that the survival of free market enterprises is contingent on those enterprises making a robust commitment to ESG principles and, therefore, to implementing a broad stakeholder governance model. Put simply, they argue that society is demanding that organizations abandon the shareholder model or else face legislation and regulations that might put them out of business.

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It is beyond the scope of this essay to address this broad concern about the survival of capitalism. In this regard, Friedman's (1970) admonition to corporate leaders is relevant. He cautioned that while there might be short-term financial advantages to cultivating the good will of politicians by pursuing and publicizing their organizations' commitments to ESG initiatives, the longer-run effect is to undermine the legitimacy of corporate profitability and, therefore, the social role of private ownership of productive assets. The ultimate supporting argument for shareholder capitalism is that the wealth created by companies committed to maximizing efficiency and long-run profitability underlies higher standards of living and the financial and technical capacity of societies to address environmental and social problems that are identified through the democratic political process. In this context, the social legitimacy of private enterprise is inseparable from the shareholder governance model.

Endnotes

1 The first major academic contribution to the model of stakeholder capitalism is arguably Freeman (1984). The development of the stakeholder model of corporate governance in the literature, including the arguments for private-sector companies to implement the model, are discussed in detail in Globerman (2022a).

2 The prominent contributions to this debate include Bebchuk and Talarita (2020a and 2020b), Mayer (2022) and Savitt and Kovvali (2022). This debate has materialized, among other ways, in lawsuits by attorneys general in several US states challenging environmental, social, and governance (ESG) investing of state employee pension monies with a lawsuit against the federal government's Labor Department and in letters that assail proxy advisory firms that have supported shareholder motions proposing corporate ESG initiatives. See Ramones and Hudson (2023).

3 See Globerman (2022b) for a discussion of similar interpretations of enlightened shareholder value versus the stakeholder model.

4 Friedman (1970) argued that it is inappropriate to delegate the job of formulating public policy to non-elected officials.

5 Bebchuck and Tallarita provide no empirical evidence either in support or against the claim that laws and regulations are more effective than the judgment calls of administrators in addressing environmental and social problems.

6 Mayer (2022), among others, argues that the social legitimacy (and even the long-term survival) of private sector businesses is contingent on their acting in a socially responsible manner which, of necessity, means implementing the stakeholder governance model either explicitly or implicitly.

7 Edmans (2023) argues that administrators currently enjoy substantial scope under current securities regulations to make decisions that they think are in the interests of their organization's financial welfare, including ESG initiatives, even if shareholders disagree.

8 For a summary discussion of the challenges to designing and implementing efficient administrative compensation schemes when decision-making spans a portfolio of activities, many unclearly defined, and that engage an array of policy instruments, see Holmstrom (2017). Edmans (2023) asserts that when stakeholder objectives are in direct conflict, it is impossible as a practical matter to link the compensation of administrators to overall stakeholder performance.

9 Conversely, Edmans (2023) argues that if some stakeholder objectives are easily measured while others are not, by having compensation linked to performance, administrators will have an incentive to promote the measurable objectives, even if the organization as a whole would be better off if the difficult-to-measure objectives were prioritized.

10 In their context, the domain of legislators and regulators includes measures such as environmental protection, product safety, and labour protection and hiring practices.

11 Savitt and Kovvali identify the linkage between the stakeholder model and the crowding out of external regulation as being the most important issue that Bebchuk and Tallarita raise—and also the latter's weakest argument.

12 Edmans (2023) rejects the claim that the shareholder model leads to inefficient investment behaviour because of unduly short shareholder time horizons. He argues that in efficient capital markets, today's share price for any publicly traded security will reflect all known actions that affect a company's net present value, both short-run and long-run. Hence, current share prices will suffer if organizations deliberately sacrifice more profitable long-run business investments in favour of less profitable short-run business investments. A decline in a company's share price hurts all shareholders regardless of their investment time horizon.

13 ESG investment strategies encompass investing in companies that score highly on environmental and social responsibility league tables as determined by third-party, independent ESG rating services. Saad (2022) discusses recent polling by the Gallup organization showing that the potential for profit and loss is the main concern of investors when choosing a stock investment. A minority say they look into corporate governance policies, or the social values advocated by company leadership before investing. Venkataramani (2021) discusses survey research done by the Gartner Group which (contrary to Gallup's results) shows that 85 percent of investors considered ESG factors in their investment decision-making. Overall, investors consider ESG investments safer and more stable than alternative investments.

14 Obviously, companies can make direct charitable donations from their retained earnings rather than distributing dividends to shareholders who can then make donations. Whether corporate philanthropy is more efficient than private philanthropy is beyond the scope of this essay.

15 Edmans (2023) discusses empirical evidence showing that shareholder proposals made by single-issue investors promoting specific environmental or social actions typically destroy long-term firm value. Shareholder engagement is more likely to create "social value" when shareholders supporting environmental and social actions on the part of their company have identical objectives, which seems unlikely in most circumstances.

16 Whether the failure of administrators to be effective agents for stakeholders is the result of deliberate malice or simply not being up to the complex decision-making required is irrelevant in this context. For convenience of exposition, we ascribe reductions in the performance of agents to deliver desired benefits to principals to the opportunism of administrators.

17 Globerman (2022c) also discusses a number of methodological caveats to empirical studies of the relationship between ESG rankings and equity returns.

18 This stream of literature can be traced back to the seminal contribution of Berle and Means (1932).

19 For example, see Mayer (2022).

20 The relevant notion of profits here and elsewhere in this essay is risk-adjusted profits.

21 It might be the case that auditing and related costs increase when companies are required to "certify" disclosures about their ESG initiatives. Shareholders should be expected to bear such increased costs, as they do for standard financial audits.

22 In equilibrium, investors should be indifferent to any company's commitment to ESG initiatives, as every company's share price will fully reflect the pecuniary and non--pecuniary expected returns relative to other companies. This nuance is not of concern here, as the basic argument for the stakeholder capital model rests on an assumption that there is broad demand for changes in corporate behaviour, i.e., capital markets are currently not in equilibrium with respect to corporate governance characteristics.

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