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On a stakeholder model of corporate governance

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Abstract

Rationales for a stakeholder model of corporate governance are based on enlightened self-interest, moral imperative, and/or externalities. Of these, the externalities rationale holds the most promise to justify a stakeholder focus. Recent evidence, however, indicates that the benefits of a stakeholder focus are limited because the social costs of many corporate activities already are internalized. Potential benefits also must be weighed against the costs, which include increased potential for conflict, waste, and managerial self-dealing. I conclude by advocating for the traditional governance model based on shareholder interests, with allowance for managers to deviate from this model in limited circumstances when the external impacts on other stakeholders are large. To constrain managerial opportunism, such deviations should be defended with a new type of double bottom line reporting, which augments traditional financial reporting with a statement of the social benefits of any deviations from shareholder value maximization.

Keywords: Stakeholders, shareholders, CSR, ESG, externalities, corporate governance

JEL Classifications: D23, G30, K42, M14, P12

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On a stakeholder model of corporate governance

1. Introduction

A stakeholder model of corporate governance promises to solve many corporate and societal problems. Firms that focus on stakeholder needs instead of only shareholder interests will engage in more CSR (corporate social responsibility) and ESG (environmental, social and governance) activities. They may become more innovative and resilient (Luo and Du, 2014; Ortiz-de-Mandojana and Bansal, 2016), have better customer and employee relationships (Greening and Turban, 2000; Jones et al., 2014; Bode et al., 2015), commit less fraud (Rodgers, Söderbom, and Guiral, 2015; Harjoto, 2017), enjoy a lower cost of capital and greater access to finance (Dhaliwal et al., 2011; El Ghoul et al., 2011; Cheng et al., 2014), have lower risk (Kim et al., 2012; Koh et al., 2014; Sun and Cui, 2014) and perform better (Flammer 2015; Matos 2020). A stakeholder focus can ameliorate corporate short-termism (Qian et al., 2019) and even income inequality and climate change (Enderle, 2018; Puppim de Oliveira and Jabbour, 2017). The U.S. Business Roundtable recently embraced these views when it endorsed a stakeholder model for business. Corporations, it proclaimed, should work for the benefit of all stakeholders – including customers, employees, suppliers, and communities – instead of focusing primarily on investors' interests. "[This] better reflects the way corporations can and should operate today."[1]

The movement toward greater stakeholder engagement and corporate social responsibility is large and impactful. Investor demand for socially responsible investing (SRI) is at unprecedented levels, as is the volume of research output on CSR and SRI (e.g., see Matos 2020). In the management and business ethics literatures especially, but also in many finance papers, the stakeholder model has become a dominant paradigm through which to examine corporate governance and the purpose of the modern corporation (e.g., see Paine and Srinivasan,

[1] Alex Gorsky, Chairman of the Board and Chief Executive Officer of Johnson & Johnson and Chair of the Business Roundtable Corporate Governance Committee, quoted in https://opportunity.businessroundtable.org/ourcommitment/, accessed October 20, 2020.

2019). Nonetheless, the arguments for a stakeholder focus remain contentious and unsettled. Vishwanathan et al. (2019, p. 317) note that "CSR is theoretically poorly defined" and that the rationale for CSR is "elusive" (Clarkson, 1995, p. 92) and "epiphenomenal" (Van Oosterhout and Heugens, 2008, p. 210). Orlitzky (2015) argues that CSR research reflects political biases, not science, and Vishwanathan et al. (2019, p. 317) argue that the rationale for a CSR focus may "… not satisfy even the most basic requirements for explanatory concepts in social science." To an outsider, much of the stakeholder and CSR literature reads like J.K. Rowling's Mirror of Erised: "It shows us nothing more or less than the deepest, most desperate desire of our hearts" (Rowling 1997, p. 157).

This paper examines the conceptual foundations of a stakeholder-based model of corporate governance. I define a stakeholder model as one that defines managers' duty of care as including an explicit and substantial weight on stakeholder interests as perceived by the manager. Although shareholders are one class of stakeholders, I use the term "stakeholder" to refer to people other than shareholders who have explicit or implicit contractual relationships with the firm and are therefore affected by the firm's activities. A firm's primary stakeholders are customers, employees, pensioners, suppliers, and affected communities. In a stakeholder model, managers have the duty to act as agents for both shareholders and stakeholders.[2]

I start with the observation that a stakeholder model matters only if it encourages managers to make different decisions than the traditional model that focuses on shareholder interests. To the extent that shareholder and stakeholder interests overlap, the stakeholder model yields no incremental guidance for managers and policymakers, or insight for researchers.

[2] The stakeholder model overlaps with "Rhine capitalism" or the "Rhineland business model," which also advocates "serving the interests of multiple stakeholders" (see https://link.springer.com/referenceworkentry/10.1007%2F978-3-642-28036-8_637, accessed August 13, 2020). The comparison is imperfect, as some descriptions of the Rhineland model (e.g., focusing on the long-term sustainability of the firm) are closer to what I describe as the enlightened self-interest rationale for a stakeholder model (e.g., see Albert and Gonenc, 1996). The stakeholder model is sometimes called "stakeholder capitalism," or presented as one aspect of "corporate purpose" (e.g., https://www.sustainabilityrisk.org/tcp). I use the term "stakeholder model of corporate governance" because it more clearly describes the essential tradeoffs involved, as discussed in Section 2.

I illustrate this observation with the framework provided by Figure 1 and use it to examine three frequently cited rationales for a stakeholder focus. The first rationale is one of enlightened self-interest, that a stakeholder focus is financially profitable too. Vishwanathan et al. (2019) call this "Strategic CSR," and argue that a stakeholder focus can improve financial performance by enhancing firm reputation, facilitating stakeholder relationships, decreasing risk, and increasing innovation. Such channels are clearly important in the value-creation process. But as a model for corporate governance the enlightened self-interest rationale for a stakeholder focus is devoid of new content because it adds no insight over the traditional shareholder model of corporate governance. This is because the enlightened self-interest rationale reduces to an admonition that managers pursue positive net present value (NPV) projects. Enhancing firm reputation, building stronger stakeholder relationships, decreasing firm risk, and increasing innovation all can be channels by which firms create value, as long as their benefits to the firm exceed the costs. But these are exactly the types of activities promoted by the NPV rule, which states that managers should pursue projects for which the benefits exceed the costs, and is the backbone of the traditional shareholder model of corporate governance.

A second rationale for a stakeholder focus is a normative claim that corporations should serve a broader social purpose in addition to their legal and economic commitments (e.g., Matten et al., 2003). This argument appeals especially to a populist sentiment that regards corporations as largely faceless entities. It can seem unfair to emphasize shareholder interests when, frequently, the firm's employees and local communities are more directly invested in the firm's operations and success. Certainly, many corporations can and do voluntarily provide goods and services for their broader communities, especially after natural disasters and during the Covid-19 pandemic.[3] Market frictions can also sustain short-term deviations from efforts to increase value. As a model for corporate governance, however, the normative argument ignores how market forces discipline

[3] E.g., see http://www.trueimpact.com/social-impact-resources/how-is-corporate-philanthropy-adjusting-their-practices-during-the-coronavirus-covid-19-pandemic, accessed August 13, 2020.

firms that pay either less than their employees' opportunity costs or more than their employees' marginal products. Firms that deviate from such rules – for any production input – find it difficult to compete in labor, input, and product markets over the long run. Catering to stakeholders for its own sake – i.e., not because it generates positive NPV opportunities – is therefore unsustainable as a governance model. The normative argument also ignores the reasons behind the long-term survival of the corporate form of organization, which includes a focus on shareholder interests. A key feature of the corporate model is that shareholders are last in line in their claims to the firms' cash flows. Focusing managers' attention on generating a return for those who are last in line generates strong incentives to satisfy the firm's commitments to all of its stakeholders. Tweaking the corporate model by making managers agents of parties who are not last in line – say, employees – is like bioengineering a change in an ostrich to make it fly. In both cases, the attempt at engineering an improvement probably ignores some important reasons things evolved as they are.

A third rationale for a stakeholder focus is based on externalities. A governance model that guides managers to consider stakeholder interests can, in theory, guide them to consider the full social costs and benefits of their actions in addition to the costs and benefits that are internalized by the firm. If externalities are prevalent and large, a stakeholder model of corporate governance can prompt meaningful changes in firms' activities, perhaps creating more value for society. Against such promise, however, we must also weigh the potential costs, which include a decrease in accountability and increase in managerial discretion, and therefore greater opportunities for managerial mischief, politicking, and private benefits. The potential costs are exacerbated because stakeholder interests are multidimensional, difficult to measure, and frequently in conflict with each other. "Externalities" are also pervasive and easy to diagnose,

even when addressing them is costlier than it is worth. Whether a stakeholder model built on concern for externalities creates value, and is sustainable, depends on the size of these costs.[4]

The rest of this essay elaborates on these themes. It is important to acknowledge the vast literature on stakeholder engagement and CSR activities. A short essay, such as this, must necessarily ignore many nuances, even in the use and meaning of such terms as "a stakeholder model" or "stakeholder engagement."[5] The Appendix to this paper addresses some of these nuances by considering criticisms of the shareholder interests model and my proposal for double-bottom line reporting. Even though parts of my analysis can be found in prior writings, this content is widely underappreciated and worthy of coverage here. In particular:

(i) Section 2 and Figure 1 propose a way to establish when a stakeholder focus matters, i.e., when it motivates different choices and activities than the traditional shareholder focus. The benefit of a new governance model depends on the changes it brings, not the actions it replicates.

(ii) Sections 3 through 5 group many disparate arguments for a stakeholder model of governance into three broad rationales based on enlightened self-interest, moral imperative, and externalities, and uses the construct in Figure 1 to examine these rationales.

(iii) Section 5 summarizes empirical research that provides content to the conceptual framework in Figure 1. Policy differences about the merits of a stakeholder model reflect different beliefs about the prevalence of activities that are privately profitable but socially costly

[4] I use the term "externality" advisedly and because it is a popular way to convey the concept that, compared to a Nirvana benchmark in which transaction costs are zero, private and social costs can diverge. As Coase (1960) establishes, however, the divergence arises from poorly defined property rights and real-world transaction costs. Anderson (2004) points out that the use of the term "externality" glosses over the nature of the social cost problem and incorrectly suggests that Pigovian subsidies and taxes typically improve resource allocations.

[5] For contemporaneous discussions of several related issues, see Edmans (2020), Bebchuk and Tallarita (2020), and Fisch and Davidoff Solomon (2020). As mentioned, I use the terms "stakeholder focus" or "stakeholder model" as referring to a model of corporate governance in which a manager's duty of care includes a substantial weight on the interests of stakeholders, broadly defined, as discerned by the manager. This is distinct from "stakeholder engagement," a term that is used to describe the processes by which firms can learn about, manage, and respond to the consequences of their projects on non-investor groups. Such engagement can be simply smart business, and is therefore fully consistent with either a shareholder or stakeholder model of corporate governance.

(i.e., in Figure 1's Quadrant IV).[6] But empirical research shows that many types of corporate activities that harm stakeholders – including consumer fraud and workplace safety violations – impose reputational costs that also harm shareholders. When market forces cause firms to internalize the costs of their actions, there is little divergence between the interests of shareholders and other stakeholders. There are other types of misconduct that can benefit shareholders but harm other stakeholders – including environmental violations and bribery – for which shareholders experience few costs. These are the types of activities in which shareholder and stakeholder interests diverge and for which a stakeholder model can motivate different corporate behaviors. Section 5 weighs this promise of a stakeholder model against the potential costs.

Overall, my analysis favors the traditional shareholder focus as a model for corporate governance. But I do not advocate van Oosterhout and Heugens' (2008) position that CSR be "discarded altogether" as a framework for corporate governance. Rather, mindfulness of stakeholder concerns serves two important functions. First, it can help focus managers' attention on all consequences of their decisions, even those that are indirect or far into the future. Paying attention to all consequences is a tenet of the NPV rule, which directs managers to pursue positive NPV projects and reject negative NPV projects. In thinking about or modeling a decision's NPV, managers might mistakenly focus only on short term or easily quantified costs and benefits. Considering stakeholder interests might help managers better implement the NPV rule and therefore better serve shareholder interests and create overall value.

Second, managers who are mindful of stakeholder concerns can, in isolated cases, voluntarily forgo projects that would impose large external costs on its stakeholder community, or pursue projects that confer large external benefits. Firms and society usually both benefit from the

[6] Duska (2007), for example, asks why anyone would do business with a businessperson who is motivated only by profit: "Does that mean [the businessperson] is likely to give you a faulty product if he can get away with it and make more profit? If he really believes what he says, aren't you a fool to do business with him?"

value-generating incentives, discipline, and clarity afforded by the traditional shareholder focus of corporate governance. And the heavy lifting of forcing firms to internalize external costs and benefits remains the domain of public policy and not managerial discretion. But situations do arise in which shareholder and stakeholder interests are not aligned and for which the legal system also does not provide a correction. In such cases, managers can (and do) impose their ethical judgment and deviate from their obligations to shareholders.

Taken too far, any proposal to promote deviations from shareholder interests is subject to the same concerns that apply to the stakeholder model of corporate governance – that it invites too much managerial discretion and waste, and too little accountability and sustainability. To limit managerial mischief, I propose that such deviations be explicitly justified and accounted for in company reports with a new type of double bottom line reporting. This is different from conventional proposals for double or triple bottom line reporting, which ask companies to discuss "profits, people, and planet" but do not focus on value or value creation. In my proposed new type of double bottom line reporting, the firm would augment its financial reports with an explicit account of the social benefits of any of its actions that do not increase shareholder value. Examples include voluntary investment in environmental cleanup or to decrease carbon emissions, forebearance from lobbying for or accepting government subsidies, or departure from an international market to promote democratic values. My argument implies that the optimal amount of managerial discretion to deviate from their obligations to shareholders is greater than zero. But any deviations should be transparent, rare, and explicitly defended as avoiding substantial harms or yielding substantial benefits to identifiable stakeholder groups.

2. Investor vs. stakeholder interests – a framework

The Business Roundtable's advocacy of a stakeholder focus has injected new life into old debates over the role of corporations, their impacts on society, and the objectives that managers should pursue. Advocates of "conscious capitalism," "ethical capitalism," or "responsible

capitalism" have advocated for a broad social concept of the corporate mission since at least the 1960s.[7] The idea is not particularly new, as John Stuart Mill and his fellow 19th Century economists pondered the moral tensions in commercial and political interactions. Even stereotyped corporate leaders from the robber baron era as such as John D. Rockefeller and J.P Morgan understood their lives and careers as serving the broader society. They not only engaged in philanthropy, but frequently worked to serve their customers' and employees' needs and intervened to help resolve macroeconomic crises (e.g., see Chernow 1990, 2004).

At the center of this debate is an obvious but difficult question: When, and to what degree, does the pursuit of shareholder interests diverge from the pursuit of other stakeholder interests? If shareholder and stakeholder interests do not diverge, a stakeholder focus does not matter because it promotes similar choices and actions as a shareholder focus. If, however, shareholder interests do not largely overlap other stakeholder interests, the debate is relevant and meaningful.

So the fundamental question is: Do stakeholder and investor interests diverge, and if so, for what types of activities? For perspective, consider Adam Smith's discussion of the Invisible Hand:

> *"[Each person] generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it ... he intends only his own security; and by directing [his] industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."*
>
> *– Adam Smith, The Wealth of Nations*
>
> *(IV.ii.6-9, page 456 of the 1776 Glasgow Edition of Smith's works; vol. IV, ch. 2, p. 477 of 1776 U. of Chicago Edition.)*

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[7] For example, see Mackey, Sisodia, and George (2014), or blog sites at https://www.consciouscapitalism.org/ and http://responsible-capitalism.org/what-is-responsible-capitalism/.

Smith's insight about the Invisible Hand has been attacked, defended, and frequently mischaracterized, ever since.[8] A close look, however, reveals one of the great discoveries of social science. It articulates an understanding of how voluntary yet seemingly uncoordinated activity by many people does not yield chaos and anarchy; rather, it promotes "the public interest." This idea anticipates Darwin's application of a parallel idea to the natural world – that lack of explicit coordination by a top-down guiding force does not necessarily imply chaos – by a couple generations. As in the natural world, order can emerge specifically from the absence of an explicit guiding hand (see Alchian 1950).

There are two important components to Smith's passage. The first is Smith's argument that the uncoordinated pursuit of private interest through voluntary exchange tends to serve the public interest. Applied to our question, this implies that shareholder and stakeholder interests often converge. Smith's second point is less obvious but just as important: he argues that the pursuit of private interest through voluntary exchange *frequently*, i.e., not *always*, promotes "the public interest." This is an important qualification because it recognizes that some types of voluntary transactions – say, between a baker and her customers – do not increase the social pie. There are many ways this could occur. Perhaps the baker's oven emits heat that kills a gardener's plants next door. Or perhaps the baker is subsidized by a government program that incentivizes too many muffins and too few pies compared to what customers want. Or perhaps the baker uses low-cost ingredients that contain chemical contaminants about which her customers are unaware. There exist many scenarios in which the baker's pursuit of shareholder interests (in this case, her own interests) do not serve the interests of some of her other stakeholders.

The alignment of shareholder and stakeholder interests is represented in Figure 1. The quadrants in the left-hand column of the figure represent activities that are profitable for the firm and therefore serve shareholder interests. The right-hand column represents activities a firm could pursue but that would not be profitable, i.e., would not serve shareholder interests. The NPV rule,

[8] E.g., for a mischaracterization, see Schlefer (2012); for a defense, see Worstall (2015).

which reflects investors' interests, encourages managers to pursue projects in Quadrant I (QI) and eschew projects in Quadrant III (QIII). (Here, it is important to remember the textbook definition of NPV as including the present value of all incremental consequences of a course of action, even uncertain consequences that are far into the future.)

The two main rows in Figure 1 partition activities that serve the interests of non-shareholder stakeholders, including customers, suppliers, employees, and communities. The top row represents activities the firm could pursue that serve stakeholder interests, while the bottom row represents activities that harm the firms' stakeholders.

QI reflects productive activities that serve both shareholder and stakeholder interests. These are positive NPV projects that also deliver value to stakeholders. For our local baker, this includes baking muffins that customers like and are willing to pay for, providing good working conditions that attract employees and encourage them to stay, paying suppliers in a timely manner, and adhering to local zoning and environmental regulations. Similarly, QIII represents activities that serve neither shareholder nor stakeholder interests – over-salting the muffins, driving away productive employees with an unhealthy work environment, or incurring fines for dumping trash illegally. Quadrants I and III, in other words, are the activities for which shareholder and stakeholder interests are aligned and for which Smith's Invisible Hand works well. If most activities a firm considers fall in these two quadrants, there is little conflict between the shareholder and stakeholder models of business responsibility. In the words of Charles Wilson, the former CEO of General Motors, "For years I thought that what was good for our country was good for General Motors, and vice versa" (see https://en.wikiquote.org/wiki/Charles_Erwin_Wilson).

The problem, of course, is that many potential business activities fall into Quadrants II or IV. QII represents activities that could benefit stakeholders but at the expense of shareholders: e.g., supporting a local homeless shelter, offering free products and services, or paying above-market and unsustainable prices for labor and services. QIV represents activities that are harmful

to stakeholders but profitable for shareholders, and potentially could include activities like consumer fraud, dumping effluents in a watercourse, building a high-density office building with little parking space that increases local traffic congestion, and paying bribes to local officials to obtain contracts.

In short, the Invisible Hand – via an investor-based model of corporate governance based on the NPV rule – works well to encourage QI activities (good for both investors and stakeholders) and discourage QIII activities (bad for both). It does not work to produce socially desirable outcomes, however, for activities in QII or QIV. Many institutions play a role in promoting QII activities or limiting QIV activities, including the political and regulatory system, the media, and the research community. The promise of a stakeholder model of corporate governance is that it can also play a role in encouraging more QII activities (good for stakeholders) and discouraging some QIV activities (bad for stakeholders) – without imposing large costs or disrupting incentives to pursue QI activities and avoid QIII activities.

3. Enlightened self-interest as a rationale for a stakeholder focus

In his classic book on stakeholder theory, Freeman (2010) cites examples in which firms succeed financially by catering to stakeholder interests. "Great companies endure because they manage to get stakeholder interests aligned in the same direction" (see http://stakeholdertheory.org/about/). Similarly, business school cases contain numerous examples of firms that focus narrowly on cost cutting to the detriment of their customers and employees, only to suffer financially in the long run. A recent example involves J. Crew, which declared bankruptcy in May 2020.[9] A classic example involves Ford Motor Company, which in the 1970s appeared to make an explicit decision not to reengineer some of its automobiles to make them safer because the cost of doing so exceeded the expected cost of customer lawsuits from injury or death in Ford vehicles. Demand for Ford Motor vehicles plummeted following a series of highly

[9] E.g., see https://www.npr.org/2020/05/22/861378110/j-screwed.

publicized tragedies involving Ford vehicles, triggering a decades-long fight for the company's survival.[10] The lesson, according to some, is that Ford's narrow focus on shareholder interests proved costly. Had Ford considered its customers' safety – that is, had Ford's decisions been driven by a stakeholder focus – it would have avoided its financial meltdown and succeeded for its investors as well.

Enlighted self-interest – doing well financially by doing good for stakeholders – therefore provides a potential rationale for a stakeholder focus. Creating value for stakeholders can be a powerful way to create value for investors. Vishwanathan et al. (2019) call such activities "Strategic CSR."

It is no doubt true that firms succeed by creating value for stakeholders. Research documents that a reputation for honesty, good working conditions for employees, and excellent service for customers are important for business success, and shows just how firms pay when they lie or cheat their stakeholders.[11] Case studies illustrate how, in many situations, catering to stakeholder relationships can help managers to consider the long-term value implications of their actions. A recurring theme of the stakeholder literature (e.g., Walsieleski and Weber, 2017) is that, by recasting and reimagining problems in light of stakeholder concerns, managers can discover win-win solutions that are beneficial to both shareholders and stakeholders.

Managing stakeholder relationships is therefore an important part of a manager's job. As a model for corporate governance, however, the enlightened self-interest rationale for a stakeholder focus adds nothing to the traditional governance model that emphasizes shareholder interests. This is because the shareholder model already directs managers to build strong teams, create supportive work environments, deliver on their promises, work to fix problems when they arise, and engage in other stakeholder-friendly activities – when doing so has positive net present

[10] The well-known story that Ford explicitly chose not to make its Pinto automobile safer, popularized by a Mother Jones article, is largely inaccurate. Nonetheless, Ford's managers did make an NPV calculation about automobile safety that contributed to a popular perception that decreased demand for its cars (see Schwartz, 1991).

[11] E.g., see the literature on corporate misconduct cited below in Section 5.

value (NPV). In terms of Figure 1, the enlightened self-interest rationale encourages managers to pursue activities that are in QI and eschew activities that are in QIII. But this is the same decision rule that is promoted by a shareholder focus. Put another way, so-called win-win solutions are already in QI and are central to implementing the NPV rule effectively.

Ford Motors' fiasco, for example, resulted not from strict adherence to a shareholder-based decision rule. Rather, the managers who calculated the NPV of improving auto safety did a poor job estimating the benefits to *shareholders* of making their cars safer. We may be appalled by a calculation that puts a value on human life. But even if Ford's managers were as indifferent to their customers' lives as this story suggests, their management error was in not anticipating customers' reaction to publicity of tragedies involving Ford cars. They got the NPV wrong. Managers misestimate costs and benefits all the time, which is why many projects succeed beyond expectations while others fail. A shareholder interests focus rewards managers who tend to get such decisions right and penalizes managers who tend to get them wrong – exactly what we want if we want firms to create value and to avoid mistakes like Ford's.

In short, the enlightened self-interest rationale for a stakeholder focus *is* the traditional rationale for a shareholder focus in corporate governance. It is a rediscovery of Adam Smith's Invisible Hand insight from nearly 250 years ago. By being mindful of stakeholder interests, managers may be better equipped to consider the cash flow impacts of their decisions (and avoid the Ford's problem). But as a conceptual framework to organize and guide managerial decision-making, the enlightened self-interest rationale for a stakeholder model provides no insights beyond those already captured by the shareholder model of governance, which directs managers to pursue positive NPV projects.

3.1. Stakeholder theory

My argument challenges some claims that stakeholder theory represents a conceptual revolution in the theory of the firm (e.g., Donaldson 2002). I believe there are two primary

reasons that a stakeholder focus is viewed as revolutionary by some commentators. First, stakeholder arguments appeal to more than the enlightened self-interest rationale for a stakeholder focus. Jones (1995) and Berman et al. (1999), for example, emphasize the benefits of considering environmental damage and community effects from a stakeholder focus – examples of an externalities argument for a stakeholder focus, which I discuss below.

Second, stakeholder theory is a "conceptual revolution" because it is compared to a straw man caricature of the traditional governance model. According to this caricature, an investor focus encourages managers to be "greedy little bastards trying to do each other in" and to focus narrowly on a subset of short term costs and benefits. This is tantamount to asserting that a shareholder focus leads firms to *not* apply the NPV rule in corporate decision-making.[12]

This straw man caricature of corporate managers – reflecting a Hollywood conception more than interaction with actual corporate managers, in my experience – is internally inconsistent. Even a coldly-calculating economic robot who cares little for others – Ebenezer Scrooge, let's say – has incentives to engage in honest dealing and to treat his customers well. Such incentives are standard fare in theories of reputational capital (e.g., Klein and Leffler, 1981). In a similar vein, Adam Smith is frequently associated with this caricature of narrowly self-interested "bastards." This is an oddity, as even a casual reading of Smith's major works reveals broad and encompassing views on the well-being of people and society. Indeed, the very first paragraph of *The Theory of Moral Sentiments* (1759) is devoted to establishing Smith's theme that people are profoundly moral creatures who care strongly about the well-being of others.

Milton Friedman's 1970 essay, "The social responsibility of business is to increase its profits" is a frequent target of critics who decry the traditional investor-focused model of corporate governance (e.g., Stout 2012). But, here too, Friedman does not advocate a Dickensian

[12] Quote from a speech by R.M. Freeman, available at http://stakeholdertheory.org/about/, accessed June 11, 2020. For a critique of the argument that value maximization promotes short-termism, see Nathan and Goldberg (2019).

vision of ruthless and myopic self-interest in which business interests exploit workers and consumers alike. In fact, Friedman points out that, in most circumstances, firms can generate profits *only* by developing strong and mutually beneficial relationships with customers, suppliers, and employees. Like Adam Smith, Friedman's argument is a forerunner of the enlightened self-interest rationale for a stakeholder model. To be sure, Friedman argues against a stakeholder focus, which he believes provides cover for managers to waste corporate resources for personal gain. Friedman's main argument about stakeholder interests is not that they are unimportant, but rather, that it is up to politicians – not managers – to establish rules that force managers to internalize costs in ways that reflect the values of the broader society.

4. Moral imperative as a rationale for a stakeholder focus

An alternate rationale for a stakeholder focus is that corporations have a moral obligation to serve the interests of the broader community over and above their legal and economic commitments. "… [I]f we say that the purpose of business is to provide goods and services, while the motive is making a profit, then the responsibility of the manager or agent of the business is not simply to pursue profits, but to pursue them regulated by the demands of the public interest" (Duska 1997, p. 1407).

The notion that corporations have a social duty to provide for stakeholders is supported by the observation that many stakeholders, including employees and customers, have significant personal investment in the firm and its operations. Many investors, in contrast, have little connection to the firm, its operations, or its products – beyond perhaps receiving a quarterly dividend check. Whereas the firm and its fortunes has a large impact on the life of its employees, it might be but one of hundreds of companies in which most investors' portfolios are allocated. Why then, one might ask, should the corporation be run on behalf of its investors? Why should it not be run in the interests of the stakeholders who seem to contribute more, and who are more directly affected by the firm?

This argument has obvious populist appeal. However, it ignores two important facts. First, it ignores that shareholders' claims on corporate cash flows are last in line. Shareholders get paid only after all other claimants are paid. Managing the firm to generate *any* return to shareholders therefore requires that managers satisfy the firm's contractual obligations to employees, suppliers, and other stakeholders. Any alternative model – e.g., managing the firm to maximize employee compensation – would create incentives to leave nothing for claimants further down the line, such as shareholders. Investors would not invest in such a firm because their risk of expropriation would be too great, and the firm would fail. The genius of the shareholder model of corporate governance is that, by emphasizing the interests of those last in line to get paid, it creates incentives to pay *all* stakeholders. If supply markets are even somewhat competitive, the incentive is to treat stakeholders well in general, as they otherwise would not contract with the firm. Stated differently, stakeholders' risk of expropriation is low precisely because managers are incentivized to serve shareholders' interests. This helps explain why the corporate form of organization evolved with a shareholder interests model of governance, and why this form of productive organization has survival value in many industrial activities. The fact that other forms of productive organization in large-scale enterprise, such as workers' cooperatives, are relatively rare, indicates that the corporate form is relatively effective at managing the myriad coordination problems that arise in complex endeavors (e.g., see Fama and Jensen 1983).

Still, a critic might argue that an investor focus creates incentives to pay too little to corporate stakeholders because any cash flow not allocated to stakeholders – say employees – can be paid as larger profits to investors. This concern, however, ignores a second important fact, the disciplining role of markets. The discipline comes from two directions. On one hand, managers cannot arbitrarily underpay their employees relative to the employees' next best alternatives because the employees would choose to work elsewhere or not work at all. The labor market forces the firm to provide a combination of pay and work amenities that is sufficient to attract employees' participation. On the other hand, competition in the product market means that

managers cannot arbitrarily pay their employees more than they are worth to the firm. It is tempting to think that investors, many of whom have deep pockets, could forgo some financial return and pay their employees more than the employees' marginal products. As a long-term business strategy, however, such an approach is unsustainable. Firms that pay employees more than their marginal products will, over time, have high production costs and not be able to compete in the product market.[13]

In terms of Figure 1, market forces bring investors' and stakeholder interests into convergence in many activities. In the words of Denis (2016, p. 472), "… [A] firm that overpays its employees relative to its competitors will not be able to compete on price, while a firm that offers lower wages than its competitors will attract lower quality employees and be unable to compete on quality. Ultimately, neither firm will be able to survive."

[13] Prior research identifies several important extensions of this argument. In actual markets, it can be optimal for firms to pay higher wages than the hypothetical equilibrium wage in a world with no informational or transaction cost frictions. For example, employers frequently have incentive to pay seemingly above-market wages to economize on other costs such as labor turnover or the cost of specialized training. As another example, labor market frictions such as monopsony power can drive a wedge between employees' wages and marginal products. Such extensions do not undermine the central importance of the disciplining role of labor and product markets emphasized here, however.

5. Externalities as a rationale for a stakeholder focus

Figure 1 illustrates the externalities rationale for a stakeholder focus. An investor focus incentivizes activities in QI and discourages activities in QIII. But what about Quadrants II and IV? The world can be made a better place if firms pursue more activities in QII and fewer activities in QIV. Perhaps this can be accomplished by adopting a stakeholder model of corporate governance. By making stakeholder interests an explicit part of a firm's mission, managers may be better incentivized to identify and pursue courses of action that benefit society (i.e., those in QI and QII) and held accountable for pursuing activities that harm the broader society (those in QIII and QIV).

This is the rationale for a stakeholder model that holds the most promise. Whether this rationale can be molded into a workable model for corporate governance, however, depends on the details. How large are the potential benefits? Can we identify activities that fall into QII or QIV and change managers' decisions in the right direction by adopting a stakeholder focus? What problems might arise? Is such a stakeholder model workable? And is it sustainable? Section 5.1 draws from the empirical research literature to consider the potential benefits of a stakeholder model, and Section 5.2 examines the potential costs.

5.1. Potential benefits of a stakeholder focus: How large are Quadrants II and IV?

The benefits of a stakeholder focus depend on whether, and how frequently, shareholder and stakeholder interests diverge. Restated, the question becomes: How common and costly are the activities in QII and QIV? These quadrants clearly are not empty, and it is easy to imagine or observe activities that are privately profitable for the firm but costly for society at large – carbon emissions, for example. Nonetheless, the theme of this section is that private transactions force many firms to internalize most costs of their activities. As a result, QII and QIV are not as large as might be imagined.

5.1.1. Some Quadrant IV activities are actually bad for shareholders, too[14]

Research into activities that fall into QIV can inform us about their frequency and cost. One form of corporate misconduct that imposes large social costs is financial reporting fraud. Giannetti and Wang (2016) find that financial fraud decreases investors' trust and participation in financial markets, potentially undermining the efficiency of capital markets and contributing to greater income inequalities as individual investors avoid participating in equity investments. Dechow et al. (1996) show that financial reporting fraud can benefit current shareholders by inflating the prices at which new investors buy shares. So it is plausible to argue that financial reporting fraud is an example of a QIV activity.

The available evidence, however, indicates that corporate financial misconduct is not privately profitable and therefore does not even place in QIV. This is because the cost of being caught engaging in such misconduct can be very large. Karpoff, Lee, and Martin (2008) report a one-day average abnormal stock return of -25.2 percent for firms subject to SEC and Department of Justice enforcement for financial misrepresentation, and Beneish (1999) finds a total cumulative loss of over 20 percent during a three-day window around announcements of GAAP violations. Amiram et al. (2018) survey a large number of studies with similar results. Furthermore, much of these firms' losses reflect lost future profits or a higher cost of capital, or both. For example, Karpoff et al. (2008) estimate that two-thirds of these firms' share value losses represents lost reputational capital, which is the present value of higher future costs or lower future revenues.

The victims of financial representation are primarily investors. But what about fraud that directly hurts non-investor stakeholders? Other activities that potentially fall into QIV involve consumer fraud, workplace safety violations, bribery, environmental violations, and other corporate misconduct. Karpoff (2012) summarizes more than 50 empirical research papers that

[14] For a related discussion, see Karpoff (2014).

examine the impacts on firms that are caught engaging in activities that appear to fall in QIV. These include false advertising, product recalls, consumer fraud, air safety failures, workplace safety violations, and defense procurement fraud. Firms that engage in misconduct that affects their counterparties – for example, defrauding consumers or violating workplace safety rules – experience large decreases in value. These firms' losses far exceed their direct costs of the misconduct, including the costs of lawsuits and legal penalties. Further evidence indicates that the losses correspond to subsequent decreases in future cash flows and/or increases in these firms' costs of capital (e.g., Murphy, Shrieves, and Tibbs, 2009).

These results indicate that misconduct that affects a firm's stakeholders tends to trigger large reputational losses. The losses are not temporary; rather, they reflect investors' expectations of these firms' higher costs and lower revenues as investors and customers shy from doing business with firms that have lax internal controls or a culture of opportunism (see Graham, Liu, and Qiu, 2008; Murphy, Shrieves, and Tibbs, 2009). The large reputational losses imply that the ex post profitability of opportunistic behavior tends to be negative for firms that are caught. The ex ante profitability depends on the probability that these firms are caught, but the overall effect of reputational penalties is to shift these activities from QIV toward QIII, making unprofitable many types of misconduct that also harm stakeholders.

This conclusion comes with an important qualification, however. The evidence shows that many types of corporate misconduct are unprofitable for shareholders if the firm is caught. If the probability of getting caught is sufficiently low, the ex ante expected profitability of some types of misconduct could be positive for shareholders. The reputational forces that make attempts to cheat new investors, customers, or employees a bad deal for shareholders work only to the extent that firms face a real threat of being caught. Research on the probability of getting caught for various types of misconduct is still in early stages (e.g., Wang 2013; Alawadhi, Karpoff, Koski, and Martin 2020).

5.1.2. Quadrant IV activities that persist

Not all types of misconduct are shifted from QIV into QIII by the force of reputation. This is because reputational losses are small to negligible for environmental violations and other misconduct that, while affecting the broader community, do not directly affect the firm's counterparties. Karpoff, Lott, and Wehrly (2005), for example, find that firms that violate environmental regulations suffer significant losses in share values that average one percent of market capitalization. These losses, however, are completely attributable to the fines, penalties, and remediation costs imposed on the polluting firms. A firm that dumps effluent into a river, for example, imposes costs on downstream users. If caught, the firm typically faces substantial fines, lawsuit settlements, and cleanup costs. But in most cases the firm's dumping activities do not directly affect its customers, suppliers, or investors. These counterparties do not face the prospect of direct harm from the firm's willingness to behave badly, so they do not have incentive to change their terms of contract with the firm. As a result, we do not observe a general tendency for environmental misconduct to harm firms' reputations with their counterparties.

More generally, Murphy, Shrieves, and Tibbs (2009) find that reputational losses tend to be negligible for frauds in which the victims do not have contractual relationships with the firm. As another example, Karpoff, Lee, and Martin (2017) find that the reputational loss for foreign bribery also is negligible. They infer that the revelation of bribery does not adversely affect the firm's counterparties, who therefore have no direct incentives to shy from doing business with the firm. To the extent that bribery is socially harmful – undermining the rule of law and the role of trust in market contracting, for example – bribery fits squarely into QIV. In fact, we can think of QIV as consisting of all such activities that impose net social harms that are not deterred by reputational penalties or other constraints.

5.1.3. Quadrant II activities

The threat of penalties, via either the market or the legal system, helps to decrease the number of activities that potentially fall in QIV. Are there commensurate rewards to firms that undertake activities in QII? One line of research that seeks to address this question examines whether firms that adopt environmentally sensitive policies enjoy abnormally high profits, values, or other benefits. However, the findings are mixed. Some researchers find evidence consistent with green policies being rewarded with increased profitability (e.g., Amore and Bennedsen, 2013). Other studies, however, conclude that environmentally friendly policies are unrelated to profitability, are the result rather than the cause of firm profitability, or are associated with poor performance (e.g., Climent and Soriano, 2011; Hong and Kacperczyk, 2009; Matos 2020).

A second line of research examines the extent to which private contracting allows firms to capture the external benefits of their actions. A widely cited textbook example of an activity that allegedly falls in QII is beekeeping. According to the theory, beekeepers provide uncompensated pollinating benefits to orchard owners – an example of an external benefit that could be resolved through public subsidies for beekeeping. Cheung (1973) examined this popular example by obtaining data on actual contracts between beekeepers and orchard owners. Contrary to the archetypal story, he finds that beekeepers do in fact capture the benefits of their bees' pollinating services. Subsequent research establishes that private contracting frequently works to internalize, and therefore encourage, benefits that otherwise would be external.[15] Such evidence implies that some activities that might appear to be in QII are, in fact, better characterized by QI.

Other activities that some might argue fall in QII are corporate policies to pay above-market prices to employees or to charge below-market prices to community groups. Such activities are not profitable for shareholders but could benefit some stakeholders. As Section 4

[15] For early examples, see Berkes (1985), Anderson and Hill (2002). Coase (1960) and Demsetz (1967) point out that, as a general rule of thumb, such external effects are internalized up to the point at which the cost of doing so exceeds the benefit of internalization.

notes, however, product market forces make such policies unsustainable as a model for corporate governance.

This is not to deny that some firms can voluntarily pay stakeholders higher-than-market prices in the short-run. In the shareholder interests model, shareholders are compensated for standing last in line when the firm pays its obligations by having the exclusive right to any surplus that is left over. Managers could rewrite this contract with shareholders by allocating some of the surplus to other stakeholders, e.g., by having profitable firms increase their corporate giving.

Many such transfers to corporate stakeholders serve the firm's long-term interests and are therefore in QI (good for both investors and stakeholders). As examples, profit-sharing and bonus arrangements are commonplace arrangements that can help incentivize employees and facilitate a productive corporate culture. Transferring corporate resources to stakeholders at the expense of shareholders, in contrast, have long-run consequences. Firms that earn a surplus over costs face discipline from the product market, as the existence of a surplus attracts competitors whose entry benefits a different stakeholder group – customers. Managers also face discipline from the market for corporate control. Shareholders stand last in line among cash flow claimants in return for the prospect of earning an above-normal return when the firm earns a surplus. Managers who persist in transferring surpluses to other parties risk the threat of takeover and ouster by investors who can profit from stopping such transfers.

Public policy frequently aims to encourage QII activities by subsidizing them enough to make them profitable for shareholders, that is, by shifting them into QI. Typical examples include education and basic research, which yield social benefits yet are insufficiently profitable without subsidies. The catch, of course, is that it is costly to identify worthy candidates for subsidization and design an effective subsidy program. Even then, the benefits may or may not exceed the cost of the subsidy. Such costs are at the center of policy debates over subsidies for electric cars, ethanol-blended gasoline, alternative energy sources, and public transportation. The debates

reflect disagreements over whether investments in such activities are best characterized by QII or QIII. Subsidy advocates argue that the targeted activities fall in QII and therefore should be subsidized, while critics argue that they fall in QIII and should not be subsidized.

5.2. Potential problems of a stakeholder model

The main takeaway from the prior section is that there is some room for a stakeholder-based model of governance to generate benefits if it can encourage managers to eschew activities that lie in QIV and pursue activities that are in QII. There is less room to generate such benefits than is widely presumed, however, because market forces already provide the appropriate incentives for many such activities. In this section I consider the potential costs of a stakeholder focus.

One potential cost is that a focus on stakeholders' interest can increase conflict over the use of corporate resources. The traditional investor-focused governance model is already challenging to implement, as information and transaction costs make it difficult to identify and pursue positive NPV projects. Shareholders also frequently disagree with each other about a firm's investment and dividend policies, and managers are imperfect agents for shareholders. The resulting potential for conflicts among shareholders is the topic of a long thread in the economics literature. An important insight from this literature is that business forms have evolved over time to economize on the cost of these potential conflicts. Corporations, for example, typically have freely tradable shares that allow minority shareholders who disagree with corporate policy to sell their ownership stakes, thereby protecting themselves from what they view as the corporation's bad decisions. Because of such mechanisms, managers can make decisions as if shareholders agree that they agree on increasing firm value, even though there might be some disagreement if shareholders were to vote on specific policies or projects.[16]

[16] See, for examples, Alchian and Demsetz (1972), DeAngelo (1981), and Demsetz (1983).

A mandate to pursue stakeholder interests, by comparison, amplifies the potential for conflicting goals. Our baker, for example, can pay for an increase in employees' wages by raising prices – a move that may be celebrated by employees and denounced by customers. Or she could use liquid assets to alleviate a short-term funding crisis at the local food bank, much to the detriment of the flour distributor to whom she owes money. If the firm's objective is to cater to stakeholder interests, which specific interests does this mean? And how can the baker balance between the competing interests of employees, customers, suppliers, and communities? So-called Fisher Separation shows that, under fairly simple assumptions, shareholders who have diverse preferences can nonetheless agree on a firm's course of action (e.g. see Fama and Miller 1972). But finding such agreement among multiple stakeholder groups remains both theoretically and practically elusive. As a result, the resolve to focus on stakeholder interests has baked into it the potential for increased conflict among the stakeholder groups. As one example, Karpoff and Rice (1989) report on a group of firms that explicitly articulate multiple stakeholder goals in their mission statements. These firms are characterized by more frequent proxy fights, more politicking by managers, more battles for control, and poorer overall performance than otherwise similar firms.

A related criticism of a focus on stakeholders' interest is that it invites managers to pursue private benefits at the expense of value creation. Maximizing shareholder value is a relatively well-defined goal. As mentioned, prior research articulates the generally reasonable conditions under which this goal facilitates low-cost resolution of potential conflicts between the thousands of diverse individuals that collectively provide long-term financial capital to a firm. A related empirical literature demonstrates that managerial labor markets and the market for corporate control work – albeit imperfectly and with significant frictions – to hold managers accountable for decisions that destroy shareholder value.[17]

[17] E.g., see Martin and McConnell (1991), Schranz (1993), and Bebchuk, Brav, and Jiang (2015).

What it means to maximize stakeholder value, in contrast, is relatively difficult to articulate and even harder to implement. The inherent ambiguity over whether and how a manager pursues stakeholder interests can therefore invite and disguise less admirable motives. Is a manager who rejects a takeover bid acting on behalf of the local community or to save his own job? Does a corporate donation to the local opera work mainly to burnish the CEO's social status in the community? If the manager's decisions are unmoored to the clearer objective of shareholder value, it becomes more difficult to hold managers accountable for their decisions.

Finally, most of my discussion accepts the stakeholder model at face value, as a directive for managers to act as agents for a broader group of stakeholders than just shareholders. It is possible that managers do not view stakeholder language as particularly meaningful (see Bebchuk and Tallarita, 2020). Alternatively, they might adopt such language for political gain. For example, the Business Roundtable's new advocacy of a stakeholder purpose might be an attempt to forestall or influence legislation that would mandate duties to stakeholders, such as The Accountable Capitalism Act (see Warren, 2018). Firms viewed as being friendly to stakeholder interests might also be subject to lower penalties in regulatory enforcement matters (Hong and Liskovich, 2015). Overall, the use of a stakeholder model could reflect an increasing trend toward corporate politicization, as firms work to influence perception, legislation, and regulation. While potentially profitable for individual firms, such rent-seeking activity is largely socially dissipative (e.g., Krueger 1974). The irony is that a stakeholder focus – which can be motivated as an attempt to limit firm activities that are characterized by QIV (good for shareholders but bad for the broader community) – may itself be a manifestation of rent-seeking activities that reside in QIV.

5.3. Limits to both the shareholder and stakeholder models

As noted, a focus on shareholder interests will encourage socially harmful investments when the external costs are large. These are QIV activities for which the shareholder model does not perform well. For many such activities, however, a stakeholder focus is unlikely to yield

unambiguously better outcomes. This is because, even for managers who try to act as impartial arbiters of the social good, it is costly to divine and cater to stakeholder interests. For many QII activities, neither the shareholder nor stakeholder models is likely to yield socially desirable outcomes, and we must rely on public policy to guide investment decisions.

As an example, the coastal plain of the Arctic National Wildlife Refuge (ANWR) is estimated to contain 7.7 to 11.8 billion barrels of oil, and the question of whether to drill for oil has been a matter of public policy debate since the 1970s. Drilling proponents argue that ANWR oil can make the United States more energy independent and create value through tax revenues, jobs, and economic development in the state of Alaska. Opponents argue that drilling would threaten a fragile ecosystem, important animal populations, and the lives of indigenous groups. Drilling could also damage the region's permafrost and adversely impact climate change.

This debate will not be resolved by a stakeholder approach to corporate governance because it is very costly to measure the net benefits to stakeholders. Should a stakeholder-focused firm that owns drilling rights be persuaded by Gwitch'in Natives, many of whom do not have significant oil claims and oppose drilling? Or should the firm listen to Iñupiat residents in the area, many of whom stand to benefit from drilling and support it? How much should the firm weigh the interests of environmentalists who live in New York and who will never visit ANWR, but who value its existence as an undeveloped natural area?[18]

Drilling and oil production in ANWR is thus an example of a policy decision that must involve the political process. Private ownership works to internalize many of the costs and benefits related to drilling (e.g., see Schaeffer and Block, 2007; Anderson 2004), but there remains widespread disagreement over whether drilling falls in QI (beneficial for both shareholders and stakeholders) or QIV (harmful to stakeholders, on net). A firm operating on behalf of shareholders is ill-equipped to consider many of the external effects. A firm that tries to

[18] For discussions of these conflicts, see Schaeffer and Block (2007), Harbell (2019), and Herz (2019).

operate on behalf of stakeholders fares no better, as it faces competing and difficult-to-measure demands from different stakeholder groups.

6. Synthesis: A new double bottom line approach

Figure 1 highlights the types of the activities in which a stakeholder agenda could promote different decisions than a shareholders-only agenda. There are benefits and costs to a governance model that emphasizes stakeholder interests over only shareholder interests. There are benefits if a stakeholder agenda encourages managers to pursue more socially desirable activities in Quadrant II (from which shareholders derive few benefits) and fewer socially harmful activities in Quadrant IV (which are nonetheless profitable for shareholders). The costs include less managerial accountability, more resource misallocation, greater conflict among various stakeholder groups, and greater diversion of corporate resources for managers' private benefits. Essentially, the costs impede the a firm's pursuit of Quadrant I activities (which are good for both shareholders and the broader community) and promote more Quadrant III activities (which are bad for both).

The potential benefits of a stakeholder approach therefore depends on the "size" (or importance) of Quadrants II and IV compared to the "size" of Quadrants I and III. As QII and QIV approach the null set, shareholder and stakeholder interests will coincide on the vast majority of projects that managers consider.

Many defenses of the traditional shareholder focus argue that most activities fall in QI and QIII, because managers can produce a profit for shareholders only if they contract honestly and ethically with employees, suppliers, and the broader community (e.g., see The Economist, 2019). Some activities, such as consumer and financial frauds, appear to fall in QIV (good for shareholders but bad for stakeholders). But the evidence in Section 5 shows that, when all costs are accounted for, these activities actually place in QIII (bad for both). Similarly, many activities that appear to place in QII (bad for shareholders but good for stakeholders) are already subject to

private contracting that incentives firms to pursue them (i.e., places them in QI) or are not sustainable for most firms (and actually fall into QIII).

This evidence indicates that most of the decisions facing managers are about pursuing activities in QI and avoiding activities in QIII. These are precisely the types of decisions that are efficiently and effectively guided by the shareholder model of corporate governance, which encourages managers to pursue activities that yield positive NPV for shareholders. For most of the decisions managers face, pursuing shareholder interests will promote long-term sustainability and social value creation. Evidence indicates that, by pursuing positive NPV projects, firms generate large social benefits as well (e.g., Nordhaus 2004).

Nevertheless, Quadrants II and IV are not literally the null set. Dumping effluents in waterways, spewing gases into the air, or bribing foreign officials to get a contract can all be profitable for some firms, and the evidence indicates that these types of activities are not heavily disciplined via market transactions and reputational penalties. Friedman (1971) argues that it is the job of politicians, as agents for the voting public, to develop laws and regulations that discourage these types of activities and encourage socially beneficial activities. Unfortunately, political and regulatory processes work with frictions, just as markets do, and there remains a meaningful set of activities for which shareholder and stakeholder interests do not coincide.

The hope for a stakeholder model of corporate governance is that it can address the activities that are best characterized by Quadrants II and IV, at least in theory. But even a narrowly construed stakeholder model risks an increased tendency for conflict, managerial opportunism, and resource misallocation. The risk of a stakeholder model is that, in the hope of addressing concerns about activities in QII and QIV, we disrupt the decision process of the shareholder interests model, which does a relatively good job of encouraging the much larger set of activities in QI and discouraging the even larger set of activities in QIII. That is, a stakeholder-focused fix is likely to create larger problems than the ones it seeks to address.

Mindful of the goal of a stakeholder approach, but also of its costs, I propose a modification to the shareholder interests model of corporate governance. I propose that – instead of replacing the shareholder-based model of corporate governance with a stakeholder model that invites conflict and waste – we expand the scope of managerial discretion to encourage managers to consider external costs and benefits when they become significant.

My proposal maintains the foundation of a shareholders-based model of corporate governance. This is a time-tested and successful component of most firms' corporate governance. It anchors managers' focus on value creation, primarily via the pursuit of activities in Quadrant I that also benefit society. And it provides for relatively clear metrics and pathways to reward and discipline managers for success and failure. Atop such a foundation, however, my proposal encourages corporate boards to grant managers the authority and approbation to be mindful of stakeholder interests and to deviate from their obligations to shareholders in limited circumstances when the external benefits to stakeholders are large.

Admittedly, such authority can be a slippery slope toward the self-dealing, wasteful, and unaccountable outcome of a stakeholder-based governance model. To constrain managerial opportunism in the name of stakeholder interests, I propose that any deviation from managers' obligations to shareholders be transparent and justified as generating significant and specific social benefits. Transparency and accountability can be facilitated by a new type of double bottom line reporting. In addition to reporting on its financial results, a company can report the private and social costs and benefits of any actions that pursue stakeholder interests, particularly when such actions do not simultaneously increase shareholder value.

To illustrate, consider Amazon's announcement to build a fleet of electric delivery vehicles as part of its goal to be carbon neutral by 2040.[19] This decision yields both costs and benefits to Amazon's shareholders. The costs are the higher direct costs of electric versus

[19] See, e.g., https://www.businessinsider.com/amazon-creating-fleet-of-electric-delivery-vehicles-rivian-2020-2.

conventional vehicles. The benefits could include lower regulatory costs, higher sales to customers who support a goal of lower carbon emissions, and non-pecuniary benefits to any Amazon shareholders who value lower carbon emissions. To the extent that the benefits exceed the costs, Amazon's decision is value-increasing for shareholders – that is, it is perfectly consistent with the shareholder interests model of governance. If Amazon's costs exceed its benefits, however, this project could be characterized by Quadrant II in Figure 1 (i.e., costly to shareholders but yielding net social benefits). If this is the case, a double bottom line approach would require Amazon to justify its decision to have an all-electric fleet by explicitly reporting to shareholders on the expected costs and the projected social benefits. The double bottom line provides discipline because it requires managers to make transparent and to justify their deviation from a shareholder focus.

My proposal for a double bottom line is different from previous proposals for double bottom line or triple bottom line reporting, which attempt to guide firms to measure and consider stakeholder interests.[20] In my proposal, a firm would not always be expected to report a double bottom line. Rather, it would report one only in periods in which managers make resource allocation decisions that deviate meaningfully from decisions that increase shareholder value. The second bottom line would be a description or estimate of the external benefits and social value of the firm's decision to deviate from its obligations to shareholders. Traditional proposals for a double or triple bottom line, in contrast, require firms to report on their social impacts in every reporting period, and whether or not such impacts arise because of, or in spite of, the firm's obligations to increase shareholder value. Traditional calls for a double or triple bottom line also do not focus on value or value creation. Rather, they would require firms to report on a variety of metrics (e.g., carbon emissions, donations, diversity hires) without considering how such metrics create either private or social value.

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[20] For definitions of previous proposals for double – or triple – bottom line reporting, see https://en.wikipedia.org/wiki/Double_bottom_line or https://en.wikipedia.org/wiki/Triple_bottom_line.

My proposal for a double bottom line that reports on the social value of any deviation from shareholder-based governance is subject to concerns about the cost of estimating and reporting such value, and the potential for manipulation and selective reporting. As discussed in the Appendix, however, the limited reach of my proposed double bottom line reporting, as well as its focus on value and value creation, make is less susceptible to such problems than traditional calls for double or triple bottom line reporting. The process by which firms create value for the world will never be exact or easily measured. But my proposal for a new type of double bottom line reporting introduces a new governance feature that can help guide firms toward value creation even in a world with externalities.

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Figure 1:
A construct for considering the shareholder vs. stakeholder debate

This figure represents four combinations of profitability and desirability for firm activities. Quadrant II represents actions that are socially desirable in the sense of being beneficial to stakeholders, on net, but that do not generate value for corporate shareholders. Quadrant IV represents activities that generate value for shareholders but are harmful to stakeholders and the broader community.

Activities that are:	Value increasing for shareholders	Value decreasing for shareholders
Beneficial for stakeholders	**Quadrant I:** Positive Net Present Value projects for which there are no significant negative externalities.	**Quadrant II:** Examples may include high environmental standards, paying "living wages," network effects, and technology transfers.
Harmful for stakeholders	**Quadrant IV:** Examples may include pollution, consumer fraud, financial misrepresentation, and bribery.	**Quadrant III:** Examples include bad products, overinvestment, underinvestment.

Appendix for "**On a stakeholder model of corporate governance"**

My analysis and proposal for a new type of double bottom line reporting raises many issues, only some of which can be addressed in a short paper on the topic. This appendix examines several questions that have been raised by readers of earlier drafts of this paper.

Q1. *Doesn't the shareholder interests model of corporate governance produce a socially desirable outcome only when markets are perfect and contracts are complete?*

Reply: This criticism of the shareholder interests model is incorrect because it commits the Nirvana fallacy. Information and transactions *are* costly in the real world. So managers who are tasked with pursuing shareholder value will rarely find the exact combination of decisions that maximize firm value according to a sterile model that assumes perfect markets. It is a fallacy, however, to compare the real-world shortcomings of a shareholder interests model of corporate governance with a Nirvana world of perfect markets. The relevant comparison is between the consequences when managers are tasked to serve shareholder interests versus stakeholder interests – both in the real world of costly information and transactions.

As argued in the paper, the information and transaction costs when trying to implement a stakeholders model of governance are particularly large because it is costly to discern the best course of action on behalf of a widely divergent group of stakeholder interests. It also is costly to measure outcomes and hold managers accountable when the objective (stakeholder interests) is multidimensional, shifting, and relatively easy to manipulate. It is precisely because of high information and transaction (i.e., contracting) costs in the real world that the theoretical hopes of a stakeholder mandate are particularly difficult to achieve. Even though the shareholder interests model of corporate governance is itself imperfect, it has proven to be so historically successful because it does a relatively good job in

incorporating and ameliorating the real information and transaction costs that bedevil all joint team productive efforts.

Q2. *Doesn't shareholder-based corporate governance work only if people care only about monetary payoffs? A stakeholder focus, in contrast, incorporates non-monetary aspects of things people care about, such as employees' work environment or a community's air quality.*

Reply: This argument is incorrect because it reflects a false Ebenezer Scrooge-like caricature of shareholder interests. It ignores how markets flexibly respond to, and cater to, both the things that people care about that are easy to value in monetary terms, and things people care about that are difficult to value in monetary terms. Take, as an example, a company's work environment. Most employees care not only about their wages, but also safety, collegiality, respect, and any other aspect of the job that affects life's pleasure and fulfillment. As is well established in the literature (e.g., Demsetz 1983), firms have incentives to provide combinations of monetary and non-monetary amenities that attract the productive talent they require to compete. Edmans (2020), for example, points out that firms that provide a respectful work environment that genuinely values employees' contributions tend to also be profitable. Providing a healthy work environment that also increases profits is a common talking point of the enlightened self-interest rationale for a stakeholder focus. But it is also a tenet of the NPV rule, which is the backbone of the shareholder governance model.

It is true that some important goods – such as clean air – are difficult to quantify, and that they can be undersupplied when managers focus on shareholder value rather than some stakeholders' concerns. The problem in such cases, however, is not that clean air is a non-monetary benefit, but that the benefit is external to the firm. The shareholder interests model of corporate governance is at least as responsive to non-monetary concerns as a stakeholder focus. But, as emphasized in the paper, it frequently does not incorporate benefits and costs that are external to the firm.

Q3. *Doesn't the pursuit of shareholder interests encourage short-termism, fraud, government lobbying, cronyism, and monopolies?*

Reply: This criticism raises several issues that have long histories in the economics and finance literature. Briefly, in three parts: (i) Yes, the pursuit of shareholder value can produce socially harmful outcomes, including political lobbying, cronyism, and monopolies. These activities must be constrained by sound public policy. Managers acting in shareholder interests would be tempted to engage in price fixing, for example, without the constraining force of antitrust laws. As for political lobbying for government favors, this is exactly the type of activity that populates Quadrant IV in Figure 1 (privately profitable but socially harmful activities). QIV activities can be either constrained or exacerbated by the political process. When the political process does not work to make such activities privately unprofitable, managers can deviate from shareholder interest, as long as they are transparent and accountable for such deviations using an approach such as the double bottom line approach that is proposed in this paper.

(ii) Public policy also works to constrain fraud. However, the evidence summarized in Section 5 shows that, even in the absence of antifraud statutes, fraud frequently destroys shareholder value. Much fraud is an example of QIII activities (privately unprofitable and socially harmful), that are constrained even in when managers pursue shareholder interests. Fraud still sometimes occur – both when managers pursue shareholder or stakeholder interests – but usually when real-world information and contracting costs provide perverse incentives for managers to engage in misconduct even when it has long-term negative consequences for shareholders.

(iii) Short-termism also can arise – again because of costly information and transactions – when share values do not incorporate long-term benefits and managers have contractual incentives to take actions that temporarily inflate share values. Short-termism is another example of a socially harmful activity that arises in the real world because of costly information and transactions. Once again, the relevant question is not to compare the harms of short-termism under a shareholder interests model with the absence of any short-termism in a Nirvana world of zero information and transaction costs. Rather,

what is the incidence and cost of short-termism in a shareholder model vs. stakeholder model of corporate governance? Here, a substantial body of evidence indicates that financial markets are relatively good – frequently better than many managers acting without any market discipline – at encouraging and rewarding a long-term focus on shareholder value. Thus, while short-termism, like fraud, will always be a problem, it is likely to be a smaller problem when managers are tasked with focusing on shareholder value, because the markets that determine such value tend to be very long-term focused.

Q4. *You advocate that managers have limited leeway to deviate from decisions that increase shareholder value. Does this mean you trust managers' judgment over that of politicians?*

Reply: Yes, but only in limited circumstances and with transparent double bottom line reporting. It is the job of the political and regulatory process to establish the rules by which firms compete, e.g., to weigh the social costs and benefits of waste emissions in the air or waterways. To the extent that laws reflect social values, firms that obey the law in pursuit of shareholder value will create value for society. The problem, of course, is that the political process also operates with information and transaction cost frictions. So some legal options that are available to firms involve external effects that are not internalized via markets or the legal process. It is when these external effects are large that a firm's activities can fall into QII or QIV in Table 1. In the paper I argue that recent evidence shows that the number of QII and QIV activities is much lower than it first appears, because market transactions cause firms to internalize most of the costs and benefits of their actions. But for the activities that remain in QII or QIV, there will be instances in which only managers' judgment will keep a firm from imposing large external costs or forgoing large external benefits.

Q5. What if shareholders are also stakeholders?

Reply: Shareholders, in general, *are* also stakeholders because they typically care about things in addition to the value of their equity stake in the firm. Let us consider the most significant way in which shareholders are also stakeholders – socially responsible investing (SRI). SRI investors typically care about more than simply pecuniary returns, e.g., the firm's carbon emissions or other ESG outcomes. As Matos (2020) reports, SRI investing can affect a firm's investment decisions. Such effects can be a form of non-pecuniary return to investors. As noted above, the observation that people care about both pecuniary and non-pecuniary things does not affect the overall rationale for a shareholder focus in corporate governance.

To the extent that a firm's shareholders disagree about the firm's ESG activities, however, the conditions for shareholder unanimity break down (e.g., see DeAngelo 1980). A breakdown of shareholder unanimity creates a conceptual problem for the shareholder interests approach that is similar to the aggregation problem with the stakeholder interests approach. This is because, without shareholder unanimity, it becomes difficult to measure shareholder value, just as heterogeneous stakeholders make it difficult to discern stakeholders' interests.

Q6. Might a double bottom approach create its own problems?

Reply: This is a valid concern. A mandate for companies to report on the social benefits of actions that decrease shareholder value imposes costs and invites self-serving manipulation. Managers could attempt to justify even self-serving actions as yielding social benefits. Even well-intentioned efforts to report and justify actions that are costly to shareholders can be costly to incorporate in a company's reports to shareholders. Any actions that are particularly costly to shareholders could also trigger shareholder lawsuits.

Despite such concerns, a double bottom line approach is likely to be less costly than the alternatives. The main alternative is so-called triple bottom line reporting, in which firms augment their financial reports with reports on their effects on employees, local communities, and the world. (The triple bottom line refers to "profits, people, and planet.") Triple bottom line reporting has gained popularity and traction among advocates of socially responsible investing and among some firms. The problem, of course, is that triple bottom line reporting can be costly, easily cherry-picked, and manipulated. Much of it may amount to little more than virtue signaling and greenwashing. Worse, it could motivate the use of company resources to generate private benefits for the firm's managers (e.g., public approbation, political appointments, and speaking gigs).

A double bottom line approach is subject to similar concerns, but with one important difference. Whereas the triple-bottom line approach asks firms to report on a wide range of metrics, among which firms can selectively choose, the double bottom line approach requires firms to focus on the value consequences of their actions – both for the firm and for the broader community. This anchors double bottom line reporting to the notion that the firm's mission is to create value. By focusing on value creation – both privately and publicly – a double bottom line report is both more transparent and more easily understood than a traditional triple-bottom line approach.

Q7. Isn't this new double bottom line approach merely a type of Quadrant I activity?

Reply: It may very well be that this new double bottom line approach generates value for shareholders, at least for some firms. Many customers, employees, and shareholders will value such reporting. To the extent they offer the firm better contracting terms (e.g., the double bottom line approach attracts loyal customers), the firm will have higher sales and lower costs. Thus, double bottom line reporting would increase shareholder value as well.

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