Harvard Law School Forum on Corporate Governance

Shareholder Value and Social Responsibility Are Not At Odds

Posted by The Honorable Mary K. Bush, Bush International LLC, on Sunday, October 25, 2020

Tags: Corporate purpose, Corporate Social Responsibility, Diversity, ESG, Human capital, Reputation, Shareholder primacy, Shareholder value, Stakeholders
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Editor's Note: The Honorable Mary K. Bush is President of Bush International LLC. This post is based on her recent article, originally published in *ProMarket*. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum **here**); **For Whom Corporate Leaders Bargain** by Lucian A. Bebchuk, Kobi Kastiel, and Roberto Tallarita (discussed on the Forum **here**); and **Toward Fair and Sustainable Capitalism** by Leo E. Strine, Jr (discussed on the Forum **here**).

The core of capitalism—the freedom to engage in entrepreneurial activities, to trade goods and services, and make profits for shareholders—in and of itself, is socially responsible. It is so because enterprises and the profits they generate bring many benefits to society including jobs and training, revenues for suppliers, R&D investment for innovation, among others. All potentially produce social and economic *returns* for individuals and businesses beyond the walls of the company. That is socially responsible.

With renewed emphasis on social responsibility, some see Milton Friedman's dedication to increasing profits for shareholders as being at odds with social responsibility. I don't see it that way at all. I think that friction between profits for shareholders and social responsibility arises, in many cases, when individual freedom is, in some way, compromised. Capitalism and individual freedom are joined at the hip. Friedman saw it that way and so do I. A weakened or severed link between the two frequently causes the friction.

As the Reagan-appointed US representative on the IMF Board, I had a timely and unforgettable opportunity to promote free markets, both through advice and lending facilities specifically designed to incorporate free market policies into the economies of African and Latin American IMF borrowers.

Witnessing many countries repeatedly in financial crisis, it became clear to me that economic growth and prosperity were stunted by government ownership of productive assets, restrictions on capital movement and business formation, and high business taxes. I thought that a new joint IMF/World Bank lending facility, structured to support privatizations and other free market reforms, would help engender growth and financial stability. Hence, we created the Structural Adjustment Facility. The results included increased business formation and economic growth along with poverty reduction and middle-class growth—all socially and economically responsible outcomes. Becoming known as Ms. Free Market made me proud. It was capitalism that drove these much-desired outcomes.

Now, though, we hear the clarion call for social responsibility. The call comes from many places including shareholders themselves. BlackRock, Vanguard, State Street, and other holders of large swaths of corporate equity are prominent promoters of stakeholder capitalism. So are many other individual and institutional investors.

Would they be sounding the call if they did not think that there is value-creating potential in stakeholder capitalism? I don't think so. I believe that they are signaling to the executive teams that manage companies that social responsibility, integrated with the business strategy and practiced smartly, has the potential to create value. They are signaling that, if companies do not conduct business in a socially responsible way, there is clear potential for weakened prospects for value enhancement and even for value destruction. The managers' duties, then, are to figure out how to merge stakeholder and shareholder interests for the good of the enterprise.

That which is for the good of the enterprise can also be good for communities, for society, and that which is harmful to communities and society can also be harmful to the enterprise, to its people. In situations where a company operates in a way that harms communities, it is more than likely compromising individual freedom of the people that comprise those communities, including its own employees.

A clear example of this is a company that dumps waste into the oceans or whose production processes pollute the air. Who is harmed? The people who breathe that air or use the ocean for leisure or even commercial fishing stand to be harmed. That may well include some of the company's employees. Those employees and their neighbors have what I would deem to be a natural right to the clean water and air that has been encroached upon by the company. Their freedom to breathe clean air and share in unpolluted waters have been diminished by a company neglectful of its social responsibility.

Is the company harmed? There are two ways that are obvious. One is that the health of its own employees could be at risk. What does that imply for medical costs for the company, for the loss of productive time for employees, for the cost of regulatory scrutiny or fines? Is there a negative impact on profits and therefore on shareholders? Likely, yes.

The second obvious harm is to the company's reputation. Will customers and investors punish the company for its negligence in protecting the environment? If so, shareholders will suffer.

Another area of social responsibility receiving long-overdue attention is that of attracting a workforce, up through the executive ranks, that is selected from a broad universe of available talent with an even hand. In other words, a diverse workforce is the issue. Other than a moral sense of fairness, what's the business imperative here? What is it that enables the company to be socially responsible on diversity while also increasing profits? McKinsey, Deloitte, and others have studied the fortunes of companies that have diverse executive teams and/or boards and compared them to companies that rank lower on the diversity scale.

A **2018 study by McKinsey** found that top quartile companies for ethnic/cultural diversity on their executive teams were 33 percent more likely to have industry-leading profitability. Top quartile companies for gender diversity on their executive teams were 21 percent more likely to outperform on profitability. Diverse boards of directors were also correlated with better performance. McKinsey concluded that these are statistically significant correlations. They were careful not to claim causality. However, the level of correlation is much too significant to be ignored.

Enhanced innovation and a heightened ability to spot, and therefore, reduce risks were highlighted in **Deloitte's review** of companies with significant levels of diversity.

When shareholders invest, they expect the company's management to assemble the best talent and the best teams of people to produce products, services, and financial results that will help assure excellent returns on their investment. Common sense tells me that, to assemble such teams, companies must select from a broad pool of talent—not a pool where some are left out because of gender or ethnicity—whether intentionally or in an *unconscious* manner.

If management does not select from the broadest pool of talent, it may well be denying the company access to individuals who are likely to make contributions that will enhance shareholder value. Moreover, for groups of people excluded from the talent pool, their *freedom of access to opportunities* is denied. I know this kind of denial of individual freedom personally as I grew up in Birmingham, Alabama at a time when Blacks and women in corporate America were a rarity and graduated from Chicago Booth at a time when the corporate world and Wall Street were just beginning to open their doors to both. The McKinsey and Deloitte studies point to the wisdom of inclusive executive teams and to the profit and shareholder value enhancement that frequently ensues.

McKinsey and Deloitte were able to quantify the value of diverse executive teams. But, not every socially responsible action can be easily quantified. Take, for instance, a company that had to furlough or reduce work hours for certain employees during the financial crisis and Great Recession and, again, during the Covid-19 pandemic. At a company that I know well, for a significant number of employees, hours of work were below that which required continued payment by the company for health insurance. Nevertheless, the company continued to provide health insurance for those employees.

The cost for this socially responsible benefit could be calculated. However, calculating the benefits to the company and to the shareholders is another story. One would have to figure out the long-term value of the retained loyalty of those employees, of their propensity to go the extra mile for the company and its customers because the company showed that it valued them as employees and as human beings in tough times.

Several companies are offering training for young people in underserved communities who might not have had access to the best education. That has a cost which will come out of current period profits. But, as with other investments, the payoff comes over the medium to longer term as those trainees become productive employees. In my view, most rational investors consider the medium and long term when assessing investments made by management. Profit increases for shareholders, to which Friedman gave primacy, may well not be the case in the year in which the cost of training is incurred. But the payoff for shareholders may well be significant in the out-years. Since this is the way that most investments are evaluated, I somehow doubt that Friedman would object.

There are plenty of opportunities for companies to *do well by doing good*. Some companies are great at attending to stakeholders while making attractive returns for shareholders. Others have barely dipped their toes in the water. Being socially responsible can, and frequently does, make good business sense. Owners and investors will continue to push companies in this direction and capitalism will, therefore, reveal more of its heart and soul.

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