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Why companies should still prioritize **wealth creation** over **wealth distribution**

Shareholder primacy WORKS

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IN CANADIAN PUBLIC POLICY

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Executive Summary

In Canada, corporate directors have the duty to act in the best interests of the company. This has, until relatively recently, been interpreted as to making decisions for the shareholders' benefit – that is, wealth maximizing decisions. Yet some within academia, the legal community and advocacy groups have argued that this focus is too narrow. In addition, in two cases since 2000, the Supreme Court of Canada has stated that directors may also consider the needs of other groups when making decisions, explicitly mentioning "employers, consumers, creditors, governments, and the environment."

In 2019 the federal government amended the *Canadian Business Corporations Act* and specifically itemized the groups that companies may consider when determining the corporation's best interest. The amendments may appear innocuous. However, they show a push towards redefining a corporation's purpose. The topic may be abstract, but its economic consequences are very real.

There are two competing perspectives vying to define a company's primary purpose: is it to undertake commerce for the benefit of its *shareholders* – those that set up and finance the company with risk capital – or to conduct business to look after constituencies that have an interest or stake in the company (i.e., the *stakeholders*, as mentioned above)? In other words, should companies emphasize wealth distribution (the stakeholder) over wealth creation (the shareholder)?

Some political leaders argue that companies should adopt a new corporate purpose that is more inclusive and sensitive to society's concerns. They believe that the corporate governance model that corporations have used over the past 50 years is misguided, and that managers are forced to make short-term decisions to maximize the company's share price. By focusing on shareholder wealth maximization, critics argue, corporate leaders are making myopic decisions that will hurt the company and its stakeholders in the long-run.

This argument disregards the reality that competition and voluntary contracting force businesses to cooperate with their stakeholders even if the company's goal is to maximize shareholder wealth. Suppliers must receive a sufficient return or they will not deal with the company. Employees must

receive competitive wages or they will leave for alternative employment. And customers will simply not buy a company's product unless it is priced competitively, is of sufficient quality, and provides useful benefits.

There is no conclusive evidence of systematic short-termism. If a corporation's purpose is to maximize its intrinsic value, by its very definition managers must make appropriate short-term and long-term decisions. And if managers treat stakeholders inadequately, it is not because of a flawed corporate purpose, but because of poor managerial decision-making.

Corporate purpose is the driver that meets society's needs and wants by competing for human, financial, and natural resources and using them as productively as possible. There is strong evidence and history that shareholder primacy works and contributes to the greater good. Replacing shareholder primacy will abrogate the market discipline imperative that forces managers to act competitively and use corporate resources efficiently – the very elements that create wealth, GDP growth, and a flourishing society.

Sommaire

Au Canada, les administrateurs d'une société ont le devoir d'agir au mieux des intérêts de cette dernière. Jusqu'à tout récemment, cette obligation était interprétée de manière à ce que les décisions soient prises dans l'intérêt des actionnaires – des décisions propres à maximiser la richesse. Toutefois, on a fait valoir au sein des milieux universitaires, de la communauté juridique et des groupes d'intérêt que cette approche était trop restreinte. En outre, depuis le début des années 2000, la Cour suprême du Canada a statué dans deux causes que les administrateurs et dirigeants peuvent tenir compte, dans leurs décisions, des besoins d'autres groupes et a cité explicitement à cet égard « les employeurs, les consommateurs, les créanciers, les gouvernements et l'environnement ».

En 2019, le gouvernement fédéral a modifié la *Loi canadienne sur les sociétés par actions* en désignant expressément les groupes pouvant être pris en compte par les administrateurs pour déterminer ce qui est au mieux des intérêts de leur société. Ces modifications peuvent sembler banales. Cependant, il s'agit d'une tentative manifeste de redéfinir la raison d'être des sociétés. L'objet peut être abstrait, mais ses conséquences économiques sont bien réelles.

Deux intérêts concurrents se disputent la définition de ce qu'est la mission première d'une société : se lance-t-elle dans une activité commerciale au bénéfice de ses *actionnaires* – ceux qui créent la société et la financent au moyen de capital-risque – ou fait-elle des affaires pour préserver les intérêts ou les participations de ses constituants (c'est-à-dire les *parties prenantes*,

comme indiqué précédemment)? En d'autres termes, les sociétés doivent-elles privilégier la distribution de la richesse (les parties prenantes) plutôt que sa création (les actionnaires)?

Certains responsables politiques soutiennent que les sociétés doivent définir une nouvelle raison d'être, plus inclusive et plus sensible aux préoccupations du public. Ils estiment que le modèle de gouvernance d'entreprise utilisé depuis 50 ans est malavisé et que les dirigeants sont contraints de prendre des décisions à court terme pour maximiser la valeur des actions. En insistant sur la maximisation de la richesse des actionnaires, les dirigeants d'entreprise, de l'avis des critiques, prennent des décisions myopes, qui nuisent à la société et à ses parties prenantes à long terme.

Cet argument occulte le fait que la concurrence et la liberté contractuelle obligent les entreprises à coopérer avec leurs parties prenantes même lorsqu'elles cherchent à maximiser l'avoir des actionnaires. En effet, les fournisseurs doivent obtenir un rendement suffisant, sans quoi ils ne concluent pas de transactions; lorsque les salaires gagnés par les travailleurs ne sont pas concurrentiels, ces derniers cherchent d'autres emplois; enfin, aucun client n'achète de produits à moins que ceux-ci soient compétitifs, de qualité suffisante et dotés d'avantages utiles.

Aucune preuve concluante de « court-termisme » systématique n'existe. Lorsqu'une entreprise a pour but de maximiser sa valeur intrinsèque, les dirigeants doivent, par définition, prendre des décisions appropriées à court et à long terme. De même, lorsque les dirigeants se comportent de manière inadéquate avec les parties prenantes, ce n'est pas en raison d'une raison d'être déficiente, mais d'une mauvaise décision de gestion.

La raison d'être répond aux besoins et aux désirs du public, car elle exprime la concurrence qui se joue pour l'obtention des ressources humaines, financières et naturelles nécessaires et leur utilisation la plus efficace possible. Des preuves solides et l'histoire démontrent que la primauté de l'actionnaire fonctionne et contribue au bien commun. Remplacer la primauté de l'actionnaire empiètera sur l'impératif de discipline du marché qui oblige les dirigeants à agir de manière compétitive et à utiliser les ressources de manière efficace – les éléments mêmes qui créent la richesse, la croissance du PIB et une société florissante.

Introduction

In Canada, corporate directors have a duty to act in the corporation's best interest. In the past directors generally interpreted this as making decisions for the shareholders' benefit. This began to change about 20 years ago. In the United States, academics, politicians, and those in the legal profession began critiquing the shareholder first governance model. The Supreme Court of Canada also ruled in two cases that directors need not only consider shareholder interests but could consider the interests of other groups with a stake in the company (Borduas 2019).[1]

In 2019, the federal government amended the *Canadian Business Corporations Act* to list the stakeholders that corporate directors may also consider when determining what is in the best interest of the corporation. The list specified shareholders, employees, retirees/pensioners, creditors, consumers, and government. Other factors listed include the environment and the long-term interests of the corporation (Canadian Business Corporation Act (R.S.C., 1985, c. C-44)). The amendments appear innocuous at first glance. However, when they are considered within the current debate in Canada on the *purpose of the company*, they show a push towards redefining a corporation's purpose. The topic may be abstract, but its economic consequences are real.

Corporate purpose is directly tied to wealth creation and economic growth, and in this matter, Canada faces some real challenges. The Organization for Economic Co-operation and Development (OECD) forecasts that Canada's per-capita GDP growth over the next 40 years will be lower than for all the other 37 OECD nations.[2] This is a scathing reflection of the low priority Canada places on economic growth (Mintz 2022).

Two competing perspectives are vying to define whether a company's primary purpose is to undertake commerce for the benefit of its *shareholders* – those that set up and finance the company with risk capital – or to conduct business to look after constituencies that have an interest or stake in the company (i.e., the *stakeholders,* as mentioned above)? In other words, should companies emphasize wealth distribution (the stakeholder) over wealth creation (the shareholder)?

Major political leaders such as Prime Minister Justin Trudeau (2018), Deputy Prime Minister and Finance Minister Chrystia Freeland (2013, 26-29), and some business executives (e.g., Mark Carney (Massoud 2021), Michael McCain 2022), and Guy Cormier (Cormier and Hyder 2021) believe that companies should adopt a new corporate purpose that is more inclusive and sensitive to society's concerns. Global Canada, a large business organization, released a report in late 2021 on the need to repurpose business and to remove the constraints of short-term thinking widespread amongst investors and managers (Global Canada 2021).

Environmental, social, and governance (ESG) proponents have also seized on "short-termism" – a charge leveled at shareholder primacy – and have called for a new, reimagined capitalism, where companies invest to create "a more sustainable, inclusive, and prosperous economy" (O'Leary and Valdmanis 2021). The debate is particularly important in developed Anglo-American countries, where shareholder primacy still reigns supreme. While there are some strong forces pushing for change in Canada, there are still many who believe it is poor policy.

The reason for a new corporate purpose, critics argue, is that the corporate governance model that corporations have used over the past 50 years is misguided. Managers are forced to make decisions that maximize the company's share price. Critics allege this singular focus leads to short-term decisions that can ignore good investments that may not pay off immediately but will benefit the company and other stakeholders in the long-term. Consequently, a corporate governance model focusing on shareholder wealth maximization is flawed, as it leads to myopic decision-making and, in doing so, ignores the legitimate interests of other stakeholders.

Keep in mind that competition and voluntary contracting force businesses to cooperate with their stakeholders even if the company's goal is to maximize shareholder wealth. Suppliers must receive a sufficient return or they will not deal with the company. Employees must receive competitive wages or they will leave for alternative employment. And customers will simply not buy a company's product unless it is priced competitively, is of sufficient quality, and provides useful benefits. A successful company needs to manage the stakeholders for everyone's mutual benefit while generating the greatest profit possible under these constraints. Finally, the government, which is another stakeholder, taxes the profits and uses the tax revenue to provide public goods such as roads, schools, health care, and other social services.

Shareholder primacy model

Under the shareholder primacy model, corporations undertake commerce for the benefit of shareholders. Given that shareholders provide the company's risk capital, they want the business to operate in a manner that maximizes the return on their invested capital. When a company is owner-managed, then a manager's decisions will be consistent with those of a shareholder's, as they are the same person. However, with joint stock companies there is a separation between those making corporate decisions (management) and those who provide risk capital (shareholders).

Shareholders, as principals, hire managers as agents to act on the shareholders' behalf. Problems occur when managers make decisions that primarily benefit themselves, rather than the shareholders. They may spend inordinate amounts on salaries, benefits, and other perquisites. They may also make business decisions that do not create shareholder value, but build a corporate "empire" that gives its managers greater power, prestige, and pay. This "principal-agency" problem is fundamental to the shareholder primacy model. As a result, the company's board of directors monitors management actions and implements incentives that tie management compensation to wealth creation.

Stakeholder model

Proponents of the stakeholder model argue that there are *constituencies* or *stakeholders* that have legitimate interests in the firm. Therefore, the firm should be obliged to consider the concerns of all stakeholders, not just those of the shareholders. Stakeholder groups are typically customers, suppliers, workers, creditors, shareholders, and the wider community in which the business operates. The wider community can include not just the town where the firm operates, but also environmental and social issues. Using a stakeholder framework, the corporation's purpose becomes greater than just to create wealth. Stakeholder advocates argue that if managers are not bound by short-term share price concerns, they will be free to make investments with a longer time horizon – investments that not only create value for the business, but for the stakeholders and indeed society overall.

Whichever corporate purpose model society adopts, the shareholder or stakeholder model, the impact on everyone will be large. Every day, the collective decisions that companies make determine what and how much is produced. Those decisions affect the cost of production, the prices consumers pay, the returns investors receive, and whether capital is used productively. The secondary effects of a company's purpose are no less important. Production decisions affect profits, which determine the amount of taxes governments receive. Thus, corporate purpose affects job creation, salaries, economic growth, and overall living standards.

Maximizing the intrinsic value of a company's shares

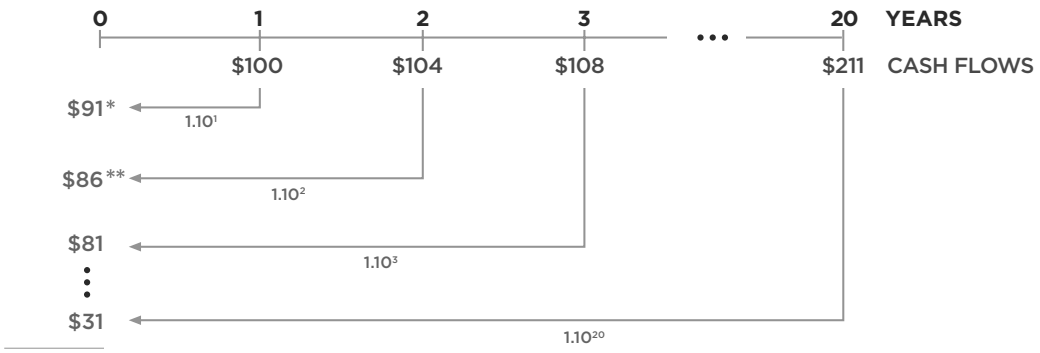
Stating that shareholder primacy makes managers focus only on short-term results is the most important argument made by critics of the model. However, there is no conclusive evidence of systematic short-termism (Summers 2017). If a corporation's purpose is to maximize the corporation's intrinsic value, by its very definition managers must make appropriate short-term *and* long-term decisions. By "intrinsic value," we mean the fundamental value, or what the company is truly worth. A company's intrinsic value is based on its expected future cash flows (one, five, 10, and 20-plus years in the future), discounted by a rate that reflects the business's overall risk. Finance theory and practice both fundamentally accept this valuation framework methodology (Brigham, Ehrhardt, Gessaroli, and Nason 2022).

A simple example illustrates why it is important to make long-term decisions to maximize a firm's intrinsic value. Figure 1 lays out the expected forecasted future cash flows for a fictious company, Acme Ltd., over the next 20 years.[3] Of course, no one knows for certain what Acme's cash flows will be. The forecast is based on Acme's most recent cash flow, future plans, expected industry growth, competition, and broader economic growth overall. We assume for simplicity that Acme's cash flow will grow annually by 4 percent on average. As time progresses and investors uncover new information about Acme, whether positive or negative, they will revise the company's cash flows accordingly. We will assume that investors use a 10 percent discount rate for Acme. The discount rate reflects many variables, including how risky investors perceive Acme's business to be. The greater the assumed risk, the higher the discount rate.

To calculate Acme's intrinsic value, we discount all its future cash flows to the present and add them up. And to find the intrinsic share price (assuming Acme has no debt), we divide the total present value by the number of common shares outstanding. In our simple example, Acme's intrinsic share price is $22.48.

Notice how the share price is determined by both short- and long-term cash flows. In fact, in Figure 1 we see that the present value of cash flows over the next three years for Acme totals $258 ($91 + $86 + $81), which is only 23 percent ($258/$1124) of the total firm's value. *Most (over three-quarters) of Acme's intrinsic value comes from expected cash flows occurring over the longer-term.* Acme's stock price will change day to day because new information becomes available regarding the company's prospects and, therefore, investors revise Acme's expected cash flow, up or down, depending upon the information.

FIGURE 1: CALCULATING THE INTRINSIC VALUE OF ACME CORPORATION'S COMMON SHARES



$1124	Intrinsic value of the firm***
$22.48	Intrinsic share price (assuming 50 shares outstanding)

$$* \quad \frac{\text{Year 1 cash flow}}{(1 + \text{discount rate})^{\text{year}}} = \frac{\$100}{(1.10)^1} = \$90.9 \qquad ** \quad \frac{\text{Year 2 cash flow}}{(1 + \text{discount rate})^{\text{year}}} = \frac{\$104}{(1.10)^2} = \$86.0$$

*** The $1124 is the summation of all 20 years of discounted future cash flows, not just the years 1, 2, 3 and 20 shown.

Five short-term fallacies used to critique shareholder primacy

Fallacy 1: Shareholders only think about the short-term

- **Part 1**

The argument regarding short-termism is weakened when we look at how investors acted during the COVID pandemic towards the cruise ship (e.g., Carnival) and movie theatre sectors (e.g., Cineplex). The very survival of companies in these industries was in serious doubt when the pandemic shut down their operations in March 2020. At that time Cineplex's management wrote that:

> The outbreak of the COVID-19 pandemic has had an unprecedented impact on all of Cineplex's business segments… with no clear date for reopening. [We may not be able] to effectively meet short-term and long-term obligations… (including interest payments, taxes, critical maintenance capital expenditures and compensation and benefits payments). (Cineplex Inc. 2020)

Cineplex's revenue in 2020 fell by over 80 percent and it reported a loss of over $600 million. Despite these awful numbers, the company found investors willing to put $300 million of new capital into the firm.

Carnival Corporation also faced massive risks. In 2020, CNBC reported that "The pandemic has basically shut down the cruise-ship business… [and Carnival]… said in a securities filing that it couldn't predict when any of its

ships would begin to sail again or when ports would reopen" (Sigalos 2020). However, while Carnival's stock fell by about 80 percent and the company reported a loss on earnings of over US$10 billion, the company still raised US$19 billion in new financing from investors (Carnival Corporation 2020, 52). That Carnival and Cineplex were both able to secure large amounts of new capital during a period of unprecedented risk strongly suggests that investors were not basing their decisions on short-term results.

- **Part 2**

Over the past 30 years, there have been some spectacular corporate success stories. Companies with humble beginnings have grown to become multi-billion-dollar businesses. Examples include Shopify and Lightspeed Commerce in Canada, and Amazon, Airbnb, and Tesla in the United States. Many others have followed a similar growth pattern. What is important to note is that these companies had investors willing to invest large amounts of capital when they had no profits – and when profits were not expected for quite some time. Some companies even have few to no sales and still attract millions in financing.

As Table 1 shows, electric car maker Tesla Inc. went public in 2010. Between 2006 and 2019, investors put in over US$12.7 billion worth of new common equity. During that same period, the company had a total cumulative net income loss of US$6 billion. Tesla's losses continued until 2020, when it finally reported a positive net income. Investors saw past the company's current and future losses, anticipating high profits further in the future.

TABLE 1: TOTAL EQUITY INVESTED DURING YEARS OF CONSECUTIVE LOSSES (US$ BILLIONS)

Company	Years of losses[b]	Equity invested[c]	Cumulative losses[d]
Shopify	2013-2019	$3.32	($0.30)
Lightspeed	2016-2021	$4.26	($0.81)
Amazon	1994-2002	$1.65	($3.01)
Airbnb	2017-2021	$11.14	($6.36)
Tesla	2006-2019	$12.74	($6.12)

[a] Data from S&P Capital IQ 2022 and author calculations.
[b] Consecutive years of loss as measured by net income from an income.
[c] Total of common stock plus additional paid in capital from the Balance sheet.
[d] Total of retained earnings plus comprehensive income and other from the Balance sheet.

• **Part 3**

On March 14, 2022, mountain resort operator Vail Resorts released its Q2 earnings. The company announced earnings per share of US$5.47, which was US$0.28 lower than analysts had forecast (Seeking Alpha 2022). Vail reported revenue of US$906 million, which was also US$50 million less than expected. That same day, its stock jumped by US$7.16, or by 3 percent. If investors had reacted to the "short-term" news, would not have the stock fallen instead?

A stakeholder proponent may react to this example by saying, "but wait, the stock did not rise due to long-term considerations. It rose because on that same day Vail announced a big dividend increase." And the observation that the stock price climbed because of the dividend increase would be correct. But it is important to note that increasing a regular dividend signals to the market positive news about the company's long-term prospects.

Since investors really dislike dividend cuts, companies will not increase their dividends unless they are confident their business can support the high dividend payment, not just in the next year or two, but over the long-term. In this case, investors ignored Vail's reported lower than expected earnings and revenue (a short-term event) but bid up its stock price based on positive long-term news. This illustration is not by any means an outlier. Investors often look past the announced earnings and try to glean new information about a company's prospects, and then buy or sell the stock accordingly.

Fallacy 2: Shareholder primacy is like fishing with dynamite

Cornell University professor Lynn Stout described shareholder primacy as producing "a one-time increase in 'shareholder wealth,' while simultaneously eroding public corporations' long-term ability to generate profits, just as fishing with dynamite produces a one-time increase in catch size while eroding long term fishing returns" (Stout 2013, p. 2016). This metaphor is incorrect. Making decisions that increase the company's intrinsic value is the opposite to the fishing-with-dynamite metaphor. Public companies invest in research and development (R&D) and fixed assets to grow and deliver future returns to shareholders. Whether it is BCE Inc. investing $4.8 billion in 2021 in its network infrastructure, or Canadian National Railway maintaining its rail network and rail car fleet, both deliver steady growth in sales and profits over the long run (BCE Inc. 2021).

The fishing-with-dynamite metaphor is more consistent with executive decision-making at a company like Enron. In Enron's case, senior management took actions to hide large liabilities, which made the company look much more successful than it was. Enron fooled the market and its stock rose for a while. But when investors uncovered its corporate malfeasance, Enron's stock plummeted and the company never recovered. The actions by Kenneth Lay, Jeffrey Skilling, and other Enron executives were certainly not made

to maximize Enron's intrinsic value for the benefit of shareholders. Their actions resulted in Enron's shares becoming worthless.

Fallacy 3: Shareholder primacy leads to underinvestment

Another argument against shareholder primacy is that companies will underinvest in their business and instead return cash to shareholders through stock buybacks and dividends. Economist William Lazonick wrote that "Trillions of dollars that could have been spent on innovation and job creation in the U.S. economy over the past three decades have instead been used to buy back shares for what is effectively stock-price manipulation" (2014, 50).

If Professor Lazonick is correct, then the lack of innovation in the past should lead to lower future profits. As shareholder primacy became the norm for companies starting in the early 1980s, we should have seen lower corporate profitability in the 1990s and 2000s because of the earlier underinvestment (Kaplan 2018). University of Chicago finance professor Steven Kaplan researched this but found that:

> it is difficult to find evidence of such effects. For example, a short-term orientation has not been reflected in any erosion of corporate profitability over time… the ratio of U.S. corporate profits as a percentage of U.S. GDP has not only been on a generally upward trend since the early 1980s but has never been higher than in the past few years. And corporate spending on R&D has also gone up sharply during this period, from 1.1% of GDP in 1977 to 1.7% in 2016. What's more, evidence of short-termism has not shown up in either higher amounts of investment, or higher rates of return, by venture capitalists and private equity firms, which are both in a good position to profit from widespread corporate failure to pursue valuable growth opportunities. (Kaplan 2018, 4)

Fallacy 4: Shareholder primacy ignores product safety

While testifying at a Joint Economic Committee at the US Congress, the Aspen Institute's Judy Samuelson stated, "When corporations put the return to the shareholder at the center of the business model, it leads to diminished investment in other critical needs – investment in both workplace and product safety (think Boeing), climate change, and conservation of vital resources (think VW and the 'dieselgate' scandal)" (Samuelson 2022).

Assuming Ms. Samuelson is attempting to equate Boeing's questionable product safety decisions and Volkswagen's diesel testing coverup with shareholder primacy decisions, she's misguided. Both companies' actions were contrary to maximizing the intrinsic value of their company's shares. Decisions to increase a share's intrinsic value should increase future expected cash flows. But Boeing's and Volkswagen's actions did the opposite.

Volkswagen lost US$42 billion in market value in the days after the scandal became public (Colvin 2020). And seven years later, the company is still working to resolve the issue (Davies 2021).

It is also interesting to note how stakeholder proponents use the Volkswagen emissions scandal as an example of how shareholder primacy ignores safety and environmental concerns. Much of the literature on the shareholder-stakeholder debate classifies German corporate governance as being closer to a stakeholder model. Professors Bottenberg, Tuschke, and Flickinger write that German "stakeholder management is highly institutionalized and anchored in laws, social rules, and norms. Thus, German firms usually exhibit a *very active stakeholder management*" (2017, 166 (emphasis added)).

Fallacy 5: Short-term focus precludes investing in environmental projects

When managers follow a shareholder primacy model, its critics argue, their myopic behaviour precludes them from making environmental investments – even those that are profitable – because the benefits accrue further in the future. But that is false. If an environmental project is long-term and financially sound, it will proceed. We can see this through a simple example using the corporate valuation model presented earlier.

Let's say a company is considering two long-term projects. The first is a new, integrated inventory management system that will cost $5 million today. Managers expect that if the system is implemented, the company will save $1.2 million dollars in annual cash expenses for the next six years. The second project costs $5 million today and will replace the company's oil-based electric generating facility with a green energy-based system. Combining lower input costs, reduced carbon taxes, and a green energy label that will improve sales, managers expected an additional $767,000 in annual cash flows over the next 12 years.

We can calculate how much each project adds in value to the company. The company believes both projects are equally risky, so a 10 percent discount rate is used to value each. The inventory management system adds about $226,000 to the firm's intrinsic value.[4] Using the same calculation for the green energy project, it too will add $226,000 in intrinsic firm value. Both projects have the same risk and return, so there is no reason to assume that the company or shareholders will prefer one over the other. In fact, since climate change measures are so important, the company will probably prefer the green project. So, there is no conceptual reason that shareholder primacy decision-making will preclude considering environmental projects.

A green project may not be financially viable if the company does not receive all the benefits (as estimated by the forecasted cash flows) that the project produces. This occurs because of existing environmental externalities.[5]

Companies sometimes pollute or emit carbon, creating environmental costs, without having to pay for those costs. If society deems the environmental damage significant, the government should tax the pollutants or carbon that companies emit. The more they emit, the more taxes they pay, and vice versa.

If pollution or carbon taxes were in effect, then the green project would have higher cash flows as the project would lower the company's carbon taxes, making the green project more valuable. In other situations, a company may not be polluting, yet it could make a green investment that would benefit society. Again, since the company will not capture the investment's benefits (because they are accruing to society and not to the company) the investment will not be financially viable. Knowing this, the government should offer incentives such as tax credits to the company making the green investment. The tax credits will internalize the project's benefits by increasing its cash flows, which would make the project more valuable to the company.

Other issues with shareholder primacy

The above arguments suggest that decisions made to maximize the company's intrinsic value for the benefit of its shareholders are not fundamentally driven by short-term thinking. The discussion also suggests that making unethical decisions to juice up short-term results contradicts maximizing intrinsic value behaviour. But do short-term thinking or unethical actions sometimes occur under the shareholder primacy model? They do.

Managers will sometimes make decisions to support the company's short-term stock price. Of course, short-term or unethical actions can also occur under a stakeholder model. If managers face pressure to take value-destroying short-term actions, companies should create incentives and managerial compensation to minimize such pressure. For instance, the move away from providing quarterly earnings guidance is part of the attempt to reduce pressure on managers to meet short-term targets. Lengthening the vesting period for executive compensation packages is another measure.

Importantly, shareholder primacy is consistent with Adam Smith's "invisible hand." Smith writes that:

> Every individual... neither intends to promote the public interest, nor knows how much he is promoting it... he intends only his own security; and by directing that 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. (Smith 1784/2007, 349)

Smith says here that individuals need not *intend* to promote the public interest, but only to *maximize their own value*. Yet it is Smith's invisible hand

that directs the business by competition, incentives, and market price signals to *promote the public interest*. The public interest here covers many parties, including those with a direct interest in business.

Stakeholder proponents invoke a false dichotomy when they state that short-term profit motives force managers to ignore stakeholder interests. They claim that the interests of shareholders and stakeholders compete, and that those competing interests are a zero-sum game, and so the only way to meet stakeholder needs is to adopt a new corporate purpose. The accompanying text box (on page 18) illustrates this false argument, showing that a shareholder primacy model is consistent with and can provide significant benefits to stakeholders. If managers treat stakeholders inadequately, it is not because of a flawed corporate purpose, but because of poor managerial decision-making.

Conclusion

Whichever side prevails and has the final say in defining corporate purpose, the result will significantly impact Canada's economy. Corporate purpose is the driver that meets society's needs and wants by competing for human, financial, and natural resources and using them as productively as possible. The shareholder primacy focus has created great wealth, allowing Canadians to attain very high living standards. Critics argue the singular focus on shareholder wealth, which they equate to stock enhancing short-term actions, sacrifices the company's long-term health and those of its stakeholders.

There is strong evidence and history that shareholder primacy works and contributes to the greater good. Replacing shareholder primacy will abrogate the market discipline imperative that forces managers to act competitively and use corporate resources efficiently – the very elements that create wealth, GDP growth, and a flourishing society.

THE FALSE DICHOTOMY OF THE STAKEHOLDER ARGUMENT: AN ILLUSTRATION

Below illustrates why wealth maximizing managed companies should deal cooperatively with stakeholders. Auto manufacturers rely on suppliers for thousands of auto components, ranging from screws to major sub-assemblies. The auto manufacturer-supplier relationship is important to the sector's business model. Stakeholder model proponents assume that actions to maximize shareholder wealth mean manufacturers use their asymmetric bargaining position to obtain the lowest possible component cost and to place onerous terms on the supplier. But that assumption is incorrect. Such actions are shortsighted; they neither add to the firm's intrinsic value, nor are they consistent with shareholder primacy.

A 2014 study linked higher auto manufacturers' operating profits with positive supplier working relationships. The authors found that the higher the suppliers' trust level, the more likely they offered price concessions and new innovations and processes (Henke, Stallkamp, and Yeniyurt 2014, 23-32). Figure 2 shows how a good supplier-manufacturer relationship leads to greater shareholder wealth. The price concession refers to the lower pricing that suppliers offer companies in high-trust relationships. Non-price benefits include suppliers offering items such as new products, or support levels greater than agreed to in the contract.

The authors conclude that:

working to build and maintain trusting supplier working relations is a prudent, financially responsible activity for every company to undertake. Second, by working to build and maintain trusting supplier working relations, the opportunity for purchasing to achieve meaningful and substantial supplier price concessions and other supplier-provided benefits is maximized. (Henke, Stallkamp, and Yeniyurt 2014, 32)

The above sounds like a strategy to maximize intrinsic shareholder value, while being true to Adam Smith's invisible hand of beneficial outcomes for others. Some will read the above and claim it is instead an example of prudent stakeholder management. Because both sides claim the above illustration as their own, the criticism of the shareholder model ignoring other stakeholders invokes a false dichotomy.

Figure 2: Relationship between suppliers and manufacturers and share holder wealth

About the author

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Endnotes

1 The two cases were, *Peoples Department Stores Inc. (Trustee of) v Wise* (2004) and *BCE Inc. v 1976 Debentureholders* (2009).

2 Data from Guillemette and Turner (2021) and author calculations.

3 In practice, future cash flows measured go on forever, since a corporation's life is potentially unlimited. For simplicity, I do not show cash flows after 20 years.

4 The $226,000 is calculated in a very similar manner to that shown in Figure 1. We use a 10 percent discount rate to find the present value of $1.2 million annually for six years. We sum those present values ($5.226 million) and subtract the cost of the project ($5 million), which we assume is money we invest today, at time zero. $5.226 million – $5 million = $0.226 million. Using the exactly the same methodology we calculate $0.226 million using the numbers for project 2.

5 A negative externality is "damage caused by a company's activities for which it does not pay" (Cambridge Business English Dictionary Undated).

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