Harvard Business Review
www.hbr.org

CEOs are rediscovering "stakeholder capitalism"—respecting the needs not just of investors but also of customers, employees, and suppliers.

Shareholders First? Not So Fast...

by Jeffrey Pfeffer

Reprint R0907K

CEOs are rediscovering "stakeholder capitalism"—respecting the needs not just of investors but also of customers, employees, and suppliers.

Shareholders First? Not So Fast…

by Jeffrey Pfeffer

It's clear that the limits of shareholder capitalism are showing themselves like so many cracks in the ages-old foundation of a house. The question is, Do the current repair efforts by senior executives and policy makers signal a lasting return to stakeholder capitalism—where CEOs feel responsible to all constituencies and not just investors?

We've been there before, after all: In the 1950s and 1960s, the stakeholder was king. CEOs saw their role as one of balancing the interests of the various groups that touched their companies—customers, employees, suppliers, shareholders, and the community at large. This reflected the executives' sophisticated understanding not only of their role as stewards of the valuable resources entrusted to them but also of their own enlightened self-interest: Each of these groups was essential for organizational success. What was true then is even more so today, in an age of knowledge work, outsourcing, global supply chains, and activist interest groups.

The idea that shareholders should be preeminent took hold in the 1970s, for many reasons. Among them was a widespread belief in the efficiency and intelligence of markets. As the University of Michigan's Gerald Davis describes in *Managed by the Markets*, society has over the past 30 years organized itself through financial markets to a far greater extent than at any point in the past. Everything is now a financial instrument: Homes aren't buildings in which you and your family live; they are options on future real estate prices. Child care, previously a personal situation for parents to wrangle with, is now a business to be traded on the stock exchange.

Markets can and do allocate resources efficiently, of course. But only under appropriate conditions—when there is lots of competition and information, for instance, and when people can make individually rational choices. Many market-solutions-for-everything advocates seem to have overlooked the point that such conditions don't always exist. Take health care: My employer chooses the options I have for health insurance. The health insurer, in turn, determines the set of doctors from which I can select, using information that is far from perfectly available or even very comprehensive.

The Pendulum Swings

Now opinions on deregulation, finance, time horizons, and the wisdom of corporate leaders are all shifting, and the logic for putting the creation of shareholder wealth ahead of the creation of stakeholder value is rightfully under fire. Given the political realignment occurring in many countries, and the residue of the worst economic meltdown and destruction of wealth since the Great Depression, the chances are pretty good that stakeholder interests will remain at the top of the list a bit longer this time.

Consider that there are literally scores of recent studies showing the gains in profitability and productivity that companies have made—not by putting investors' interests first but by implementing high-commitment work practices. These include investing in training, decentralizing decision making, and having pay be contingent on organizational, not just individual, performance. Other sources show the benefits companies reap from customer loyalty and high levels of customer satisfaction.

A broad collection of balanced scorecard and other assessment tools also helps to refute the idea that financial measures of performance should be the primary (or only) ones employed. Furthermore, there's no legal basis for giving shareholders exclusive priority. As Yale professor Constance Bagley and coauthor Karen L. Page made clear in their 1999 *San Diego Law Review* article, "The Devil Made Me Do It," managers can justify practically any course of action by declaring it to be in the name of shareholders, even if it imposes great costs on others. But no laws require them to do so.

Even in terms of sheer logic, shareholder preeminence fails the test. As Dennis Bakke, the cofounder of the energy corporation AES, has asked: "Why should past labor (capital) receive so much preference over current labor (employees)?" The idea that stock markets are invariably efficient and provide accurate estimates of value has been shot down time and time again: Witness the rise over the past few years in the number of earnings restatements filed and the number of companies that have gone from being "most admired" to "most reviled" almost overnight.

The Proof Is in the Companies

If all that evidence isn't compelling enough, a dose of competitive analysis might do the trick. Even in an era focused on shareholder wealth, the outperforming companies have been those that have gone against the grain and embraced stakeholders. Look at Southwest Airlines, which had at one point a market capitalization equal to that of the rest of the U.S. airline industry combined. From the very beginning it has put employees first, customers second, and shareholders last. Even following the industry shutdown after the terrorist attacks on September 11, 2001, the company never had layoffs. Similarly, shareholder interests bring up the rear at Men's Wearhouse, which now sells almost a quarter of all men's suits in the United States. The company aids employees in financial distress and invests heavily in worker training. It competes not on price but on the quality shopping experiences it offers its customers.

Shareholder capitalism is no longer something that resonates inside organizations. It doesn't motivate or engage the workforce in a way that engenders high performance; maximizing shareholder value is scarcely the kind of big, hairy, audacious goal *Good to Great* author Jim Collins has described as being so useful for getting people on board with your ideas. Customers, for their part, care about the quality of the goods and services they're getting and how they're being treated—not about stock price. And suppliers seek partnerships based on trust and mutual commitment for the long term, not share appreciation.

In the end, shareholder returns are just an outcome of management practices that respect all constituencies. Maybe this time CEOs will get it. If they don't, we'll be traveling back to the future once more, with yet more rounds of scandal and recession.

Reprint R0907K
To order, see the next page
or call 800-988-0886 or 617-783-7500
or go to www.hbr.org

Jeffrey Pfeffer (pfeffer_jeffrey@gsb.stanford.edu) is the Thomas D. Dee II Professor of Organizational Behavior at Stanford University's Graduate School of Business in California. His latest book, *Power: An Organizational Survival Guide*, is forthcoming from HarperCollins.

Further Reading

The *Harvard Business Review* Paperback Series

Here are the landmark ideas—both contemporary and classic—that have established *Harvard Business Review* as required reading for businesspeople around the globe. Each paperback includes eight of the leading articles on a particular business topic. The series includes over thirty titles, including the following best-sellers:

Harvard Business Review on Brand Management
Product no. 1445

Harvard Business Review on Change
Product no. 8842

Harvard Business Review on Leadership
Product no. 8834

Harvard Business Review on Managing People
Product no. 9075

Harvard Business Review on Measuring Corporate Performance
Product no. 8826

For a complete list of the *Harvard Business Review* paperback series, go to www.hbr.org.

Harvard Business Review
www.hbr.org

U.S. and Canada
800-988-0886
617-783-7500
617-783-7555 fax