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Firms Behaving Nicely: Incentives and Commitment

Michael Klein

Foreword by Colin Mayer



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Forum



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Firms Behaving Nicely: Incentives and Commitment

Corporate Governance, Social Responsibility, and the Profit Motive

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Table of Contents

Foreword	IV
Abstract.....	VI
1. Introduction	1
2. Shareholders.....	3
The Corporate Governance Debate.....	3
Disciplining Agents of Shareholders.....	6
Shareholders and Short-termism.....	8
Proving Adam Smith Wrong: Reform and Progress	12
3. Stakeholders	14
The Value of Contracts, Laws, and Regulations for Stakeholders.....	14
Voluntary Self-Control: Reputational Mechanisms.....	17
4. The Search for Credible Commitment Mechanisms	21
The Challenge	21
Suppressing the Profit Motive: Nonprofit Firms	22
Commitment Devices.....	25
5. The Way(s) Forward	27
The Historical Verdict, So Far	27
Openness to Innovation.....	29

Foreword

It is more than 50 years since Milton Friedman first presented what has now come to be known as the “Friedman doctrine” in his book *Capitalism and Freedom* (Friedman 1962). This states that social responsibility is a “fundamentally subversive doctrine” in a free society and in such a society “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”

It has been a powerful doctrine that has not only been used to justify corporate conduct and government policies toward the firm around the world but has also been the basis of a business education that has molded generations of business leaders. It reflects the power of ideas to influence behavior to a point that many people now believe that the Friedman doctrine is a law of nature from which, like it or not, we are unable to escape.

At the end of Chapter 8 of *Capitalism and Freedom*, Milton Friedman provides an explanation: “A major complaint made frequently against modern business is that it involves the separation of ownership and control—that the corporation has become a social institution that is a law unto itself, with irresponsible executives who do not serve the interests of their stockholders. This charge is not true. But the direction in which policy is now moving . . . is a step in the direction of creating a true divorce between ownership and control and of undermining the basic nature and character of our society. It is a step away from an individualistic society and toward the corporate state.” In other words, corporations are the instruments of individuals, their shareholders, and “‘business’ as a whole cannot be said to have responsibilities. . . . Only people can have responsibilities” (Friedman 1970).

Half a century on, we are beginning to understand not just that this is wrong but also why it is wrong. Not only can businesses have responsibilities that are distinct from us as individual owners, managers, or employees, but also society is fundamentally enriched by them. As I discuss in my book, *Firm Commitment* (Meyer 2013), the corporation is a remarkable institution. It can contract and be contracted, employ and be employed, and sue and be sued—just like the rest of us. But it can achieve much more than we can. It can provide degrees of commitment to which we as individuals can only aspire, and in the process it can overcome the deficiencies and failures that otherwise impoverish us. It can do this on account of the separation of ownership and control—that which in a conventional context and in Friedman’s eyes is regarded as a deficiency of the corporation is an attribute allowing it to balance the degree of commitment it offers to different parties with the control that it exercises over them.

Michael Klein builds on these ideas to describe eloquently the dilemmas that confront those running and regulating the modern corporation. There are conflicts that make conventional prescriptions for the corporation fundamentally flawed. While we look to contracts to protect the interests of stakeholders other than shareholders in the firm, those contracts are highly imperfect and the position of stakeholders is frequently not so dissimilar to that of

shareholders. Without adequate protections, neither shareholders nor stakeholders are willing to make commitments in the form of irreversible investments. Even shareholders themselves are not a uniform class, and conflicts between different types, for example between short- and long-term shareholders, threaten the long-term prosperity of corporations.

As Michael Klein goes on to note, apparently straightforward policy prescriptions such as corporate social responsibility and not-for-profit organizations are rarely panaceas. They have deficiencies that suggest that there is unlikely to be a single form of corporate organization that is best suited to all activities. Instead, we should look to diversity of corporate form to promote an alignment between the ownership, governance, and control of corporations and their business needs.

The traditional economic description of the corporation is deficient on account of an overemphasis on contracts, incentives, and control at the expense of obligations, responsibilities, and commitment. Trust underpins all economic activities, and economies flourish and fail to the extent that they establish or undermine institutions to support and promote it. The corporation is one of the most powerful institutions of trust and is capable of providing the balance between commitment to and control over the parties to the firm appropriate to its activities. That is what corporate governance should seek to achieve, but increasingly, and partly in response to the Friedman doctrine, it has become hijacked by one interest group in society, and that is its shareholders — and, increasingly, short-term shareholders at that.

What is required and what Michael Klein's paper helps us do is to rebalance the interests of different parties so that the corporation can once again undertake what it is supposed to do — to produce goods and services that benefit us as customers and communities. In the process, it generates profits for its shareholders, but these should be a product of, not a purpose of, the corporation. An appropriate balance of interests not only promotes economic efficiency, enhances the commercial performance of corporations, and increases the competitiveness of nations, but it also encourages ethical conduct. Far from divorcing normative concerns of corporations from their commercial interests as Friedman has suggested, they should be closely intertwined so that firms can “behave nicely” and once again become institutions that we value and trust.

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Abstract

Ever since the rise of large firms in the 18th century, debate has been raging about how to combine economic efficiency and productivity with socially desirable behavior of firms. This paper reviews the debate, starting with the classic corporate governance argument about shareholder rights. It discusses the potential incentives to exploit other stakeholders unduly and examines some mechanisms, beyond contracts and regulation, to cope with this exploitation. In this light it considers reputational mechanisms, using the example of corporate social responsibility, and changes to the constitution of firms, with emphasis on the nonprofit form of enterprise. Based on evidence so far, the for-profit firm with mechanisms assuring sound shareholder rights remains preferable to the alternatives. However, scope for experimentation with mechanisms such as different classes of shareholders with differing voting rights may be socially useful, which suggests that global corporate governance principles thus should not be prescriptive in detail.

1. Introduction¹

The modern firm is a recent invention. For most of history, small family businesses were the most complex economic organizations. Even large plantations in colonial North America rarely had as many as 300 workers (Chandler 1977). In 1766 in Birmingham, England, Matthew Boulton opened the first factory that employed over 1,000 workers at its peak.

Ever since the modern firm started conquering the world, disputes over its social contribution were rife. In 1776, Adam Smith argued that “it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest” (Smith 1776). Serving people what they want is the way to profit. Thus the pursuit of self-interest is compatible with helping others.

Not everyone agreed. Some people thought untrammelled self-interest would lead firms to exploit workers. In 1786, David Dale founded the New Lanark textile factory and village near Glasgow, Scotland. Influenced by the utopian socialist ideas of Robert Owen, the new community featured reduced working hours, education for children, and improved housing for workers — an early example of social impact investing.

Company law was still in early development at the time. The first modern company law, Britain’s Joint Stock Companies Act of 1856, was almost a century away. It combined simple company registration and the principle of limited liability, which had just been enshrined in legislation the year before.² In 1863, the British Alkali Acts were passed, the first modern environmental laws.

From the very beginnings of capitalism, the recognition of the power of private enterprise³ supported by the profit motive went hand-in-hand with criticism of the abuse of workers, communities, and the environment. At the same time, experiments with new forms of firms and management proceeded apace and affected legislation and regulation.

Today there is renewed and vibrant interest in finding ways to combine the productivity of firms with ethical behavior. Recently, the goal of deploying the power of enterprise for the social good was expressed, for example, by Bill Gates in a speech at the World Economic Forum in 2008, particularly to help people in developing countries (Gates 2008).

This Focus sets out key arguments about the ways in which firms may be constituted to pursue goals beneficial for humankind. First, it discusses the debate about shareholder rights, or corporate governance, followed by a review of mechanisms to protect and help other

1. I gratefully acknowledge comments from Tatiana Nenova, Motoko Aizawa, and Colin Mayer.

2. Just a few years before, in 1848, Karl Marx and Friedrich Engels published the *Communist Manifesto* in London.

3. “[The bourgeoisie] has been the first to show what man’s activity can bring about. It has accomplished wonders far surpassing Egyptian pyramids, Roman aqueducts, and Gothic cathedrals” (Marx and Engels 1848).

stakeholders, such as employees, communities, or the environment. Then it reviews voluntary mechanisms, such as corporate social responsibility (CSR), and legal ones, such as nonprofit incorporation. Social impact metrics or the triple-bottom-line (“people, planet, profit”) are supposed to underpin incentives for firms to behave well. This Focus surveys existing approaches and sets out what we can expect from them. Finally, it discusses mechanisms to hardwire good behavior, such as incorporation as a nonprofit firm.

2. *Shareholders*

Modern firms are complex organizations. For them to be efficient, the interests of many parties, the “stakeholders,” need to be aligned. Stakeholders include not only customers, employees, suppliers, and financiers (creditors and shareholders) but also the communities where firms operate and the environment.

The Corporate Governance Debate

Managers are supposed to make this alignment of interests happen. Within a framework of rules, managers exercise their discretion to run firms. These rules, and the processes and organizational arrangements that go with them, are the domain of corporate governance.

Definitions

In the widest sense, “corporate governance is the system by which companies are directed and controlled.” This is the definition adopted in 1992 by the Cadbury Committee, a well-known commission on corporate governance in the United Kingdom.

More focused definitions of corporate governance emphasize “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer and Vishny 1997). The most narrow definition concerns the alignment of incentives for insiders (managers or controlling shareholders) to serve the interest of all shareholders. Providers of finance need to be confident that corporations have the right incentives to make a return, and they need to trust that if there is a return their funds are not misappropriated.⁴ The discussion on how to align interests among stakeholders, particularly financiers, sets up the key issues.

Contracts for financiers: Debt versus equity

Creditors providing debt to firms are helped by relatively simple contracts. They are to be repaid according to a fixed schedule. They also tend to require that borrowers maintain adequate levels of equity so that default risk is remote. If money is not repaid as contracted, the borrower is in default and may be taken over by the creditors in some form of bankruptcy process.

Shareholders providing equity to firms require more complex contracts. Their return is not fixed. The good news is that shareholders therefore have an “upside” in addition to a “downside.” They have a chance to make extra money if the firm does well, whereas creditors only face “downside” risk. The bad news is that shareholders need to trust that firms do not hide profits and that they do not divert them. Carl Fuerstenberg, a German banker who lived

4. For a discussion on this “agency problem,” see Jensen and Meckling (1976).

from 1850 to 1933, characterized the problem thus: “Shareholders are stupid and impertinent. Stupid, because they entrust their money to people they do not adequately control. Impertinent, because they ask for dividends and thus even want to be rewarded for their stupidity” (Hellwig 1998).

The core shareholder rights issue: Control rights versus rights to cash flow

In small family firms, shareholder control is not a major issue. The family provides the equity and owns the firm; it has as much control as anyone could hope for. Family-owned firms have their own problems, but those are typically not directly related to the nature of financing contracts. Typical issues are fights among family members or disputes over succession of control — for example, when the founder dies.

For external financiers, an issue arises when they provide funding to companies in which they exercise only limited control. In equity finance, this issue plagues minority shareholders in companies that are controlled by large shareholders — the typical situation in most of the world (La Porta et al. 1999). Controlling shareholders may exercise control by owning a majority of shares, or they may control the majority of voting rights with just a small part of the total shares. The corporate governance problem then is how to protect minority shareholders from potentially harmful (expropriatory) actions by controlling shareholders.

In the United Kingdom and the United States, however, many large companies are held by widely dispersed, relatively small shareholders with limited control rights.⁵ The resulting issues were brought to prominence by Berle and Means in their 1932 book, *The Modern Corporation and Private Property*. Here shareholders may find themselves at the mercy of managers who pursue their own goals or simply fail to maximize the value of the firm.⁶

For both minority shareholders and small, dispersed shareholders the issue can be characterized as a divergence between rights to cash flow and control rights. Such shareholders may have a right to returns, but they do not exercise control. In 1776, long before today’s debates about corporate governance, Adam Smith set out the essence of the principal-agent problem: “The directors of [joint-stock companies], however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company” (Smith 1776).

Modern research finds, across many countries and time periods, that firms that are run by controlling shareholders perform relatively well. Performance suffers when control and cash flow rights diverge substantially. This applies both to controlling shareholders who hold a small share of the equity (for example, through shares with preferential voting rights)⁷ and to

5. In Japan and Korea, shareholdings may also be widely dispersed, but shareholders often exert control via cross-shareholdings.

6. For review of the issues, see Shleifer and Vishny (1997).

7. A recent case is Google: <http://dealbook.nytimes.com/2012/04/13/new-share-class-gives-google-founders-tighter-control/>.

companies where ownership is dispersed and control exercised by managers who incidentally may also own some shares (Bebchuk and Weisbach 2009).

The attraction of equity with weak control rights

While concentrated control in the hands of big majority shareholders may help performance, it also limits financing options. To attract finance from the public at large, including through contractual saving plans such as pension funds or insurance companies, firms need to inspire trust that they will treat shareholders fairly. Otherwise they may not be able to raise such finance or may do so only on expensive terms, driving up the cost of capital.

At the same time, many people would like to participate in the return from equity. Equity securities have often outperformed investments in bonds by a substantial margin over long periods, enjoying an excess return referred to as the equity premium. Notably in the United States, the equity premium has been close to 7 percent over the last century. The excess return may be explained as compensation for extra risks taken when investing in equity securities.

Much of the corporate governance debate is thus concerned with mechanisms for incentive-compatible ways of matching the demand and supply of external equity finance. The key incentive for firms to improve corporate governance is the search for more funds at lower cost. But how strong is that incentive?

Attracting low-cost equity: An incentive to respect noncontrolling shareholders?

Firms typically fund only a limited share of investments through issuance of equity (Hellwig 2000). Retained earnings and debt finance play a larger role.⁸ Retained earnings can be invested by decision of those who hold control rights, without going to the market. Creditors are more easily persuaded to part with their money, because they have contracts that can be relatively easily monitored. This yields the so-called “pecking order” of corporate finance, whereby retained earnings are used first, followed by debt, and equity last. Once small shareholders have committed their funds (for example, at the time of an initial public offering), the controllers of the firm may have weak incentives to uphold good corporate governance standards. The corporate governance scandals of the early 2000s provide several examples—such as ENRON, where shareholders lost everything as the company was run into the ground. In particular, employees participating in ENRON’s pension plan were obliged to invest all their pension savings in ENRON stock. Their pensions were wiped out.

A widespread mechanism to steal from minority shareholders is tunneling or the exploitation of “related-party transactions.” For example, a controlling minority shareholder in a firm may exploit other shareholders by selling overpriced goods or services to the firm from another company, in which he owns the majority. To the extent of his minority shareholding, he thus suffers a little from the loss imposed on the firm from paying too much, but he benefits to the

8. Retained earnings also belong to shareholders. The fact that much investment is financed by retained earnings is not an argument for playing down shareholder rights in favor of those of other stakeholders, as some stakeholder advocates support.

extent of his majority shareholding in the selling company. If he owns 25 percent of the firm, but 75 percent of the vendor company, he thus gains 50 percent of the excessive price.

Corporate governance problems are particularly stark for small retail investors. Large ones can afford to pay for research and may be able to obtain adequate controls contractually. Small investors hope to use the stock market as a place for saving, such as for retirement. They typically invest via a pension fund. All the people handling their money, their “agents,” pay themselves from it—including, for example, trustees of pension funds as well as board members and managers of investee firms. The willingness of the agents to treat investors well is not automatically assured.

The issue is gaining further salience as populations in rich countries are aging and returns may be attractive in emerging markets. It takes convincing for people to invest a part of their savings in the Nigerian stock market, even though it is possible that the world’s growth will come more and more from Africa over the 21st century.

Disciplining Agents of Shareholders

So how can we get agents all along the agency chain (trustees, fund managers, board members, managers, and so on) to pursue shareholder value and not make unnecessary, wasteful payments—or steal—along the way? Broadly we might distinguish two ways of making firms responsive to shareholders: first, by increasing the powers of shareholders; and second, by aligning incentives along the agency chain.

Powers for shareholders

Boards of companies supervise management and represent shareholder or stakeholder interests. This is called the “fiduciary duty” of the board. Board structures vary between countries. German companies, for example, have supervisory boards (Aufsichtsrat) that are to watch out for shareholders by supervising the managing board (Vorstand).

The power of shareholders is enhanced when they receive adequate information, allowing them to judge whether firms respect their financing contract. Making board directors of companies liable for abusing shareholders, in combination with the right of shareholders to sue them, makes it possible to act on the information.⁹

Measures also exist to provide shareholders with powers prior to any potential abuse. Such measures include giving shareholders rights to nominate board members, strengthening the hands of minority investors through cumulative voting,¹⁰ or providing them with a “say on pay,” the ability to affect remuneration of top managers.

9. The World Bank’s Doing Business project (World Bank 2012) captures this combination of measures via the global ranking of shareholder rights.

10. In an election for more than one seat, cumulative voting allows small shareholders to accumulate their votes by putting more than one vote on a preferred candidate, thus making it more likely that they will get at least one person of their choice on the board.

Incentive alignment

Ideally, of course, shareholders would like managers to pursue shareholder interests on their own volition rather than as a result of corporate battles. One mechanism to help align interests is to reduce conflicts of interest, importantly the potential for related-party transactions.

Conflicts of interest

A current high-profile issue is the question of whether chief executive officers (CEOs) of companies may also act as chairpersons of the board. In the United Kingdom and Canada, for example, it is common to separate the positions. In the United States, traditionally CEOs were often also chairpersons. Lately, however, the corporate governance movement in the United States has led to an increase in companies where the chair is separate from the CEO — from some 27 percent of firms in 2004 to about 40 percent of firms in 2011 (Flannery 2011). Whether this will make a serious difference in performance remains to be seen. Studies do not tell a clear story that one type of arrangement outperforms the other. Famously, in ENRON the position of CEO and chair were split — to no avail for shareholders.

Executive compensation

At the core of mechanisms to align incentives in the agency chain are compensation mechanisms (Fama and Jensen 1983). In a well-known article in the *Harvard Business Review* in 1990, Michael Jensen and Kevin Murphy wrote, “the compensation of top executives is virtually independent of performance. On average, corporate America pays its most important leaders like bureaucrats. Is it any wonder then that so many CEOs act like bureaucrats rather than the value-maximizing entrepreneurs companies need to enhance their standing in world markets?” (Jensen and Murphy 1990). Since the 1980s, top managers of large companies in the United States have been remunerated more and more with pay or bonuses tied to stock performance, typically stock options (Milgrom and Roberts 1992).

While suspicion about CEO pay is rife and examples exist that underperforming CEOs were well-paid, overall CEO pay in the United States, outside the financial sector, seems driven by company performance (Kaplan 2012).¹¹ Pay tends to vary with performance; underperformers are replaced more quickly, and CEO pay has declined over the last 10 years and is back at the levels of the early 1990s, although still above previous levels.

Nevertheless, perfect alignment of interests is hard to achieve, and vigilance on the part of shareholders or their representatives remains important. For example, stock options may be backdated at times to allow managers to benefit from a lower base price. Stock options may also induce managers to seek excessive risk, since they benefit from upside but their downside is limited.

11. In discussing evidence on executive compensation, Milgrom and Roberts (1992) came to a similar view.

The market for corporate control

Shareholders further benefit from a functioning market for corporate control that allows hostile takeovers—takeovers that are against the wishes of incumbent management.¹² A market for corporate control tends to be financially attractive for existing shareholders. In such a market, bidders for the company bid up the price of the company to the point where all possible future financial gains are passed on to existing shareholders, including gains that the incumbent management was unable or unwilling to obtain.

Hence shareholders welcome limits on “poison pills,” mechanisms that make hostile takeovers hard. For example, so-called “shareholder rights plans” may act as poison pills. Under such a plan, existing shareholders in a company can buy new shares at a discount in case some shareholder’s overall holdings exceed a percentage of shares that would make it likely that the large shareholder might mount a takeover bid. To make sure that all shareholders benefit equally from the market for corporate control, so-called tag-along rights provide small or minority shareholders the right to benefit from a deal on the same terms as controlling shareholders.

Leverage

A key reason why managers may be able to exploit shareholders is their command over retained earnings—free cash flow inside the company. Such managerial freedom is circumscribed when mechanisms are in place that take cash out of the firm. The market for corporate control can achieve this result, as corporate raiders pay existing shareholders the premium on their share value that was not realized under incumbent management.

Another mechanism involves the use of leverage—that is, funding a greater proportion of the firm with debt (Hart, 1995). Debt contracts require regular debt service payments that reduce cash in the firm. The remuneration of equity on the other hand is at the discretion of the firm. Debt contracts also provide outside financiers with some control rights over the financial behavior of the firm.

A number of firms mimic debt service payments by committing to predictable dividend payments, which affect cash in the same way as debt service payments. Firms can decide to alter these payments, but such decisions send a signal that the firm may have trouble managing its finances, so firms tend to alter dividend payments only as a last resort.

Shareholders and Short-termism

A fundamental critique of shareholder rights asserts that the pursuit of shareholder value leads businesses to focus on the short term and to neglect creating value in the long term. A typical fear is that the search for shareholder value will unduly favor cost cutting over long-term value creation.

12. Note that effective control may be exercised with less than 50 percent of shares via pyramid schemes, cross-holdings, or corporate holding strictures (Nenova 2006).

One way of dissecting the debate is to distinguish three issues. First, does the pursuit of shareholder value intrinsically lead to a focus on the short term? Second, does frequent monitoring of short-term performance hamper the long-term focus? Third, are there incentives to systematically misrepresent information at the expense of long-term value generation?

The time horizon of shareholders

The pursuit of shareholder value means maximizing the value of shares in a company. This does not mean that profits should be maximized period-by-period. The price of shares reflects the discounted value of the stream of net profits into the indefinite future. It may be good for shareholders to accept lower profits in certain periods, if this were to lead to longer-term value creation.

The time horizon induced by the principle of maximizing shareholder value thus extends into the indefinite future. It easily exceeds, for example, the standard time horizon of the average politician and that of most, if not all, other stakeholders in the firm. Short-term creditors, for example, would be happy if they get paid, even if the company goes under right afterwards. Incumbent politicians of the community where firms operate might be happy if the firm hires more workers prior to elections, even if it undermines the longer-term viability of the firm. In general, the people who have short-term outlooks are the other stakeholders (including managers) that like to divert resources, which they have no clear contractual right to, for current issues.

Of course, shareholders may sell their shares rather than hold onto them. Listed, liquid shares enable shareholders to get rid of their stock at any time with little transaction costs. Does this reduce the time horizon they are interested in? The price they will receive for their stock depends on the buyer's expectations of the future net profit stream. So managing a company for the long term will in principle maximize the value for existing shareholders, even if they intend to sell stocks early. For example, shareholders of tech stocks were happy with very long-term views in the run-up to the dot.com bubble of the early 2000s. Investors happily bought companies that did not even have positive earnings (profits). Instead of using price-earnings ratios to assess the value of stocks, some analysts and investors seemed content to work with price-revenue ratios.

Short-term performance benchmarks

In practice, many corporations focus much management effort on short-term results. For example, listed companies in the United States have to prepare quarterly accounts that allow analysts and shareholders to assess company performance. Managers thus try to make companies look as good as possible on an ongoing basis. The question is whether this attention to short-term results is to the detriment of longer-term value creation.

How does a firm actually manage for the long term? There may be a company strategy and plans. Managing against such longer-term goals requires attention to what happens along the way. Managing with the help of short-term yardsticks and checks makes eminent sense. For all sorts of endeavors in the life of firms, or private life for that matter, it makes sense to break

down long-term strategy into short-term milestones (like breaking down a reading list into so many pages per day). Achieving the milestones is a way of checking to see whether the strategy is on track. Such milestones sensibly include short-term financial performance. Other short-term indicators are those commonly found on so-called balanced scorecards. Such scorecards allow managers to track performance on the basis of indicators that are available in the short term but are deemed to be predictive of long-term overall success.

Misleading information

If markets correctly see that, for example, undue cost cutting now lowers long-term value, that would reduce share prices, and the quest for making the short term look good would undermine the share price. This brings out the main issue in the debate on short-termism, namely the quality of information available to investors. At times, of course, information may be wrong. The real issue is whether managers or employees generating the information have an incentive to systematically mislead investors.

Incentives to misrepresent information

The average top manager typically can expect to spend about 10 years or less in a company before retiring. So the manager might have an incentive to boost compensation now to the detriment of shareholders. To do so, particularly if his or her remuneration is dependent on share price performance, the manager needs to find ways to boost short-term performance so that investors will, at least on average, believe it lifts long-term performance.

Corporate governance scandals provide clear evidence that some companies or their managers have provided misleading information. ENRON, for example, created all sorts of off-balance-sheet vehicles where it parked debt while taking advantage of any method allowing the company to book revenues early. Typically, there are warning signs that diligent stock market analysts can pick up on, and that was the case with ENRON. Obviously, however, it is possible for some managers to fool enough investors for long enough to make the provision of misleading information potentially attractive. The incentive to fool investors into buying stock is a classic case of the market for lemons.¹³ When it comes to selling an item, sellers have incentives to provide misleading information, and buyers need to beware. The outcome, on average, would be a shrinking of markets, unless improved market infrastructure such as corporate governance regulations or reputational incentives overcome the lemons problem.

A key financial trick: Making profit by hiding risk

A key strategy for fooling investors is to make present profits look good while hiding future risks. Financial products lend themselves to this especially well. Consider the following example, taken from Mayer (2013), which illustrates a fairly generic strategy for making a financial firm look good—for now. (Of course, the firm could also be one, such as ENRON, that combines the sales of financial products with that of so-called “real” goods and services.)

13. The term “lemons problem” is derived from economist George Akerlof’s demonstration of the concept of asymmetric information through the example of defective used cars, which are known as lemons in the marketplace. In the investment field, the lemons problem is apparent in areas such as insurance and corporate finance.

Here is the recipe: To show that you are a world-beating asset manager, set up a fund aimed at beating benchmark return set by treasury bills. For the sake of argument, assume that to be 4 percent. As fund manager you get a 2 percent fee on assets under management and 20 percent of excess returns you manage to generate above the benchmark. With the help of an exciting prospectus, you raise \$100 million. That is a hurdle, but many funds have been able to pass it in the last decade.

In addition, sell options against a 1-in-10 chance event—for example, the chance the sun might shine in London, as Colin Mayer facetiously puts it. You get \$1 now, but have to pay out \$10 if the sun shines. Selling 11 million options will give you revenue of \$11 million. Now take the \$100 million and the \$11 million, use \$1 million to pay for operating costs, and invest the remaining \$110 million in treasury bills yielding 4 percent.

The revenue you earned for investors is \$4.4 million in interest payments plus \$11 million from selling options. Your total revenue is thus \$15.4 million—a 15.4 percent return on the \$100 million of assets under management, or 11.4 percent above the benchmark. You gain \$2 million (2 percent of funds under management) plus \$2.28 million (20 percent on excess return of \$11.4 million) every year. You earn this with probability of 90 percent—until you get wiped out.

That was in essence the strategy of AIG (American International Group), the giant insurance company that collapsed during the 2008 financial crisis and was bailed out by the U.S. government. The traditional insurance business of AIG was in decent shape. However, the AIG financial products division sold large numbers of credit default swaps that insured buyers against defaults of mortgage securities.¹⁴ AIG looked good for a while. Then the mortgage market collapsed, and it brought down the whole of AIG. The strategy may not have been to intentionally dupe investors; AIG itself may have had trouble understanding risk and may have been blinded by apparently strong short-term results.

Incentives of buyers: Beware or follow the herd?

Common sense and economic theory tell us that people who have something to sell are likely to put a positive spin on things. So buyers should be cautious and buy only at a discount or not at all. That is the core argument of theories regarding asymmetrically distributed information. In practice, however, the recommended caution may be overridden by episodes of optimism, when the behavior of the “herd”—often including politicians and regulators—shapes the expectations of individuals.

To some extent, herd behavior may be unavoidable. The world is full of information that we cannot possibly hope to analyze in full. We know it could be biased. But we also cannot afford to stop all interactions. So, to a degree, we need to go with “generally accepted” opinion. That may often be a good heuristic, but at times we suffer the consequences.

14. Key staff of the financial products division were previously at Drexel Burnham Lambert, which collapsed in 1992 after junk-bond-related scandals.

Proving Adam Smith Wrong: Reform and Progress

After every scandal, solutions are sought to prevent recurrence. Where misleading information is the issue, remedies involve better accounting standards, better auditing, more useful disclosure, better incentives for analysts, and reduction in conflicts of interest. But perfection remains elusive. Buyers still have to beware.

Troubles with reform

The very reform processes that are to improve corporate governance are often shaped and driven by those who are to be controlled, particularly managers of firms. Hellwig (1998) provides a variety of examples of ways managers shape corporate governance mechanisms in their favor. Bebchuk, Fried, and Walker (2001) found that executive compensation practices might be better explained by the concept of rent-seeking managers¹⁵ than by theories of shareholder value.

So the worries of Adam Smith were not all off-the-mark. Corporate governance scandals have become a recurring spectacle. In the early 1990s, the BCCI (Bank of Credit and Commerce International) scandal rocked the corporate governance world. Reforms followed, and by the early 2000s the International Monetary Fund reported that corporate governance “practice is improving.” The scandals involving companies such as ENRON, WorldCom, and Global Crossing led to further legislation, notably the Sarbanes-Oxley Act in the United States. Measured by indicators of the quality of corporate governance around the world, policies improved again in the 2000s.¹⁶

Then came the scandals of the 2008 financial crisis. As Warren Buffet put it, “It’s only when the tide goes out that you learn who’s been swimming naked.” In crises, risky strategies come to an end. The Bernie Madoff pyramid scheme was a prime example, but so were the aforementioned AIG problems.

Reform: Not perfect, but good enough

And yet, globally, equity markets have grown over the years. The richer the countries become, the larger the equity markets tend to be. More and more people are exposed to risk in equity markets—via mutual funds, for example, or more importantly via pension and insurance plans. But despite all of the problems, policy reforms and firms’ practices have been good enough, so far, to instill sufficient confidence in an increasing number of investors to take the risk of becoming a shareholder, directly or indirectly. The ability of companies to lower their cost of capital by improving shareholder rights may prove to be important after all. Firms with better corporate governance may be the ones that outcompete others and survive. Brazil provides an example: in 2000, it launched a new listing segment on its BOVESPA stock

15. The term “rent seeking” describes using resources to obtain economic gain without giving any benefits back to society (or in this case, shareholders) through wealth creation.

16. See the World Bank’s Doing Business Reports from 2003 to 2012.

exchange that featured tougher corporate governance standards than the traditional market, protecting minority shareholders better.

New scandals presumably will occur. Retail investors are more at risk as, for example, pension plans have shifted risks on investors by moving from defined-benefit to defined-contribution plans. In a way, the corporate governance agenda seems to operate like a game of whack-a-mole: as soon as you hit one problem on the head, another one pops up. And yet, overall, Adam Smith has been proven wrong so far: the key for investors is to assess the trustworthiness of a firm; the issue for the firm is the ability to commit credibly to principles or actions.

3. Stakeholders

When managers focus on maximizing the value of the firm, they serve the interests of shareholders. All other stakeholders — customers, employees, suppliers, creditors, communities, and the environment — are protected by contracts or laws and regulations.

The Value of Contracts, Laws, and Regulations for Stakeholders

According to economists such as Milton Friedman, when managers pursue shareholder value it is also good for society at large. Profit maximization by firms will create the largest possible “pie” that is distributed to stakeholders.

Standard protections for stakeholders

According to Friedman, when contracts have been concluded in workably competitive markets and laws and regulations adequately protect stakeholders, profit maximization will lead to the best outcome for all. He writes, the “responsibility [of corporate executives] is to conduct the business in accordance with their [employers’, that is, shareholders’] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom” (Friedman 1970).¹⁷

Shareholders protecting future stakeholders

When shareholders are effectively in charge, they also help represent a set of stakeholders that few if any others care about, namely future stakeholders. Shareholders may keep their money in the firm as retained earnings and let managers invest it. Alternatively, they can take the money they have invested in the firm and invest it elsewhere. For example, they may do so via share buybacks by the firm or by using the dividends they receive rather than putting them back into the firm. When corporate raiders take over a firm, existing shareholders receive the expected efficiency gains in the form of higher share prices. Many firms pay out funds to shareholders and then go to the stock or debt markets and raise money again. This might seem a waste, unless the decisions about the investments of shareholders differ depending on whether they are made by their agents, the managers, or by shareholders themselves (Mayer 2013).

The investment opportunities that managers have are typically related to the business of the firm. Managers may also benefit personally from expanding their firm. Shareholders invest in any related or unrelated activity in pursuit of profit, driven by incentives in the market. When the investment opportunities of the firm are either limited or not very profitable, it would be

17. In the same article, Friedman also states the proposition as follows: “. . .there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”

better for overall economic growth to invest in new businesses with better prospects. Leaving the decision to shareholders rather than to managers makes this better outcome more likely.

The stakeholders in new businesses often do not exist yet. They are the future employees or the communities where new businesses thrive. Stakeholders of existing firms may fear for their jobs; they do not care about future, better jobs. Shareholders, however, are only interested in enhancing value. So their interest coincides with that of new entrants and new workers (Hellwig 2000), that is, stakeholders that are otherwise not yet represented and who may still go to school and develop their ideas and skills.

Gaps in contracts, laws, and regulations

However, the notion that stakeholders are well-protected by contracts, laws, and regulations is not quite accurate. Contracts are by nature “incomplete” (Hart 1993). For example, employment contracts may specify broad parameters of duties and obligations and, sensibly, leave discretion to managers over how to direct employees on an ongoing basis. Laws and regulations are likewise incomplete, or there may be gaps in them. The ruthless pursuit of profit may lead firms to exploit any ambiguity in contracts, laws, or regulations to the benefit of shareholders and the detriment of stakeholders. Presumably to prevent this from happening, according to Milton Friedman, firms and their managers should adhere to “ethical custom” (Friedman 1970). But such custom may be ill-defined and unenforceable. Hence the profit motive may ride roughshod over such concerns. This hurts stakeholders when they cannot just walk away from the firm.

When contracts, laws, and regulations do not effectively cover all aspects of shareholder relationships, special attention to stakeholder concerns might be justified to the detriment of shareholders. Of course, that opens a can of worms, because by definition it is not clear what the intent of the law is or what ethical custom requires. Firms thus face the dilemma of setting out a corporate ethic—explicitly or implicitly—to deal with the gaps and to balance shareholder and stakeholder interests.

Sunk, firm-specific investment: Ex post opportunism

There is also a deeper problem. Shareholders have given their money to the firm but do not have a clear-cut contract, such as creditors have, to assure themselves of a return. They have sunk the money in the firm and are thus at the mercy of management. However, this is true not only for shareholders but also to varying degrees for other stakeholders. The issue is whether any stakeholder has made sunk, firm-specific investments that are at the mercy of the firm’s decision makers. Employees, for example, may have invested in firm-specific knowledge that is of little use elsewhere. Once creditors have invested in a firm, their money also is at the disposal of management, notwithstanding the apparent simplicity of a debt contract.

Consider the following case, which again is borrowed from Colin Mayer's book, *Firm Commitment*.¹⁸ Suppose a firm has total assets of \$300, funded with debt and equity in equal shares of \$150. Now imagine that management is fully responsive to shareholders and has to decide on a project with the following key features: With equal probability it will either double the value of the assets of the firm or wipe them out completely. If the project succeeds, the assets are worth \$600, and shareholders have tripled their investment to \$450. If the project fails, shareholders lose everything, but the private wealth of shareholders is unaffected due to limited liability. The expected value for shareholders is thus \$225, or a gain of 50 percent. Creditors also lose their investment in case of failure, because they have no recourse to the private wealth of shareholders, and they have no gain in case of success. Their expected value is thus \$75 or a loss of 50 percent. Shareholders or their representatives thus have an incentive to gamble with the assets that others have dedicated to the firm. Those with firm-specific investment and without participation in the upside are at the mercy of shareholders.

Note that the smaller the share of equity, the greater the temptation to gamble. This can be a burning issue in financial institutions such as banks, where capital is often less than 10 percent of assets. When banks are in trouble, management is often tempted to "gamble for resurrection" by making huge bets that would save the firm if they work and hurt creditors when they go wrong. "Perfecting corporate governance" in banks enhances the incentive to gamble. Better corporate governance may thus fuel financial risk and crises rather than help reduce volatility. The much-quoted words of Citigroup's CEO Chuck Prince are to the point. In July 2007, during the run-up to the financial crisis of 2008, he told the Financial Times that the party would end at some point. "When the music stops, in terms of liquidity, things will be complicated," he said. "But as long as the music is playing, you've got to get up and dance." Then he added, "We're still dancing."

Ex ante risk premiums to cope with the risk of ex post opportunism

Stakeholders in a firm are generally aware of the incentives that govern managers and the shareholders ex post. Hence ex ante creditors will require contracts that circumscribe financial decisions by the firm or take collateral. Employees will negotiate such agreements as severance payments to guard against the risk of firm failure. Ex ante, those contracting with the firm will require some form of compensation for risks they take. These risks may result from gaps in contracts, laws, and regulations or from the danger associated with firm-specific investment.

In the end, various stakeholders are exposed to the consequences of opportunistic behavior of others when they have sunk investments that are specific to the firm. Otherwise they could walk away without loss. In this sense, all stakeholders, including shareholders, are in the same boat. Shareholders just have a very complex contract. Those that enter into contracts with a firm voluntarily will ex ante assess the risk of ex post exploitation and demand a risk premium in return. Firms can reduce such man made risk by credibly committing to sound principles and actions — and they do so, often effectively.

18. The argument is also presented in textbooks such as *Economics, Organization and Management*, by Milgrom and Roberts (1992).

Voluntary Self-Control: Reputational Mechanisms

Firms have an incentive to maintain a reputation for honest behavior ex post, because it will reduce the risk premiums required by stakeholders ex ante. The phenomenon of corporate social responsibility can illustrate the issues well. The term CSR is a fashionable way of encompassing a variety of stakeholder management issues, whether they concern the treatment of employees, local communities, or environmental pollution. Firms are supposed to care about the “triple bottom line” (people, planet, profit)—also sometimes characterized as “doing well by doing good.” This approach encompasses the gains to firms from maintaining a decent reputation for not exploiting stakeholders ex post.

Corporate social responsibility

The term CSR can be thought of as encompassing four basic types of cases.¹⁹ First, there may be cases where paying attention to stakeholder issues yields profitable investment opportunities. Michael Porter has called this win-win proposition “shared value investing” or “impact investing.” An example might be energy-efficiency plans that reduce greenhouse gas emissions while also saving costs for firms. There is really nothing special here; it is simply a case where profit-maximizing behavior is consistent with socially or environmentally sound behavior.

Second, some customers are willing to pay extra for “fair” or “green” products from firms that behave in ways that protect, for example, workers in the supply chain. These tend to be niche products, such as fair trade coffee. Again, doing business in this way is compatible with profit maximization and could also form part of “shared value” initiatives or “impact investing.”

Third, many corporate social responsibility activities are related to maintaining a good reputation—so as not to lose the license to operate, for example. A firm may generate goodwill by investing in community health care and schools. Behaving responsibly may reduce the threat of protests, strikes, or new regulation. Participation in CSR is in the long-term interest of the company and, again, consistent with maximizing shareholder value. Related are efforts to brand companies as good citizens as a way to attract employees who want to work in nice firms. Although this practice is widespread, it is not clear that many employees are willing to accept jobs for lower pay just because a company is branded as “socially or environmentally responsible” (Kitzmueller and Shimshack 2012).

All three of these types of CSR activities are consistent with Milton Friedman’s view of what corporations should legitimately pursue. In each one there is a business case that is in the interest of shareholders.

Fourth, firms may pursue social or environmental goals that lower profitability at the expense of shareholders. Socially responsible investment funds, for example, may eschew investment in “unhealthy” or “dirty” sectors. A whole class of such funds has developed, along with special market benchmarks such as the Dow Jones Sustainability Index. Intriguingly, such funds

19. For a practitioners’ review of cases, see IFC (2002); for an academic review of arguments and evidence, see Kitzmueller and Shimshack (2012).

typically advertise with the proposition that investing in good things will also increase returns. That would then simply reduce this case to a variant of the previous ones. The Dow Jones Sustainability Index is almost by construction focused on a lot of firm-level practices that are for the most part good management practice, such as sound human resource management.

However, some social impact investors, such as the Acumen Fund, promise only modest returns for shareholders wanting to invest in good things. Some others, such as U.S. pension funds, decided in the 1990s not to invest in tobacco stocks, and they underperformed as a result. The evidence so far suggests that shareholders typically do not pay for CSR (Kitzmueller and Shimshack 2012). In some of the pension funds mentioned above, the antitobacco policy came under pressure when employees saving for pensions saw that they missed stock appreciation in dirty businesses.²⁰ At the same time, when investors move capital toward good things, return on bad things may increase. This has given rise to investment vehicles such as the Vice Fund in the United States, which invests only in tobacco, arms, alcohol, and gambling.²¹

It is hard to tell what the whole set of social investment initiatives adds up to, but one thing is clear: any special effort by firms to help stakeholders needs to be paid for by someone. Broadly, it seems that shareholders are reluctant to participate in donative activity via their shareholdings.

Social and environmental results measurement

Any reputational mechanism requires a means of information feedback to stakeholders. Stakeholders need to be able to assess whether a firm is living up to its promises. Based on this information, stakeholders decide whether to continue to trust the firm. For example, more investors might be willing to invest in firms for reduced return if they could more clearly measure the results. Lovers of fair trade coffee, for example, want to know whether the coffee was actually purchased from farmers at “fair” prices.

Measurement approaches

Measurement and evaluation of CSR initiatives are still sketchy. However, a whole industry has sprung up promising to provide results measurement for social and environmental activities. One of the more punchy promises is to find ways to create a triple bottom line that allows firms to manage holistically, not just for profit but for people and the planet as well.

Prominent initiatives include the Global Reporting Initiative (GRI), Impact Reporting and Investment Standards (IRIS), and Global Impact Investing Rating System (GIIRS). GRI provides a framework and guidelines to measure, report on and rate a company’s economic, environmental, social and governance performance. IRIS provides a collection of impact-related indicators for all sorts of businesses. Examples of its popular “reach” indicators might be how many people were reached by microfinance initiatives or how many children were sent to school. GIIRS promises an overall rating of readiness and impact.

20. Based on personal information from fund managers.

21. A similar fund proposal in Germany was squashed through regulatory opposition.

Most initiatives produce assorted indicators that are hard to aggregate and lack any weighing of costs and benefits. Existing ratings are judgments of limited value. For example, under GRI standards, which are based on self-assessment of the extent of disclosure suggested by GRI, Shell carries an A rating and Amnesty International a B rating. So should someone give donations to Shell and not to Amnesty? Compared to social impact ratings, agency ratings of collateralized debt obligations look informative. Only a few organizations attempt to provide cost-effectiveness measures, and they do not do so consistently (Tuan 2008).

Only one bottom line

In the end, none of the initiatives comes anywhere near generating data that would allow calculation of a true social or environmental “bottom line.” A real accounting bottom line is capable of capturing all relevant costs and benefits and of aggregating them, with the help of prices or shadow prices,²² into a measure of net benefit produced by a firm. This is feasible only when we have prices for all relevant costs and benefits, a relatively rare case. Even when it is feasible, the new bottom line does not provide an incentive to maximize it unless shadow prices are somehow transformed into real monetary rewards—for example, via some form of donation. Hence the talk about alternative bottom lines may make good copy but is hardly enlightening.²³

What it all comes down to is that firms can try to project a responsible image, and they can support their claims with more or less eclectic measurement of relevant features of their efforts. There is nothing wrong with this; it is like setting out characteristics of any product or service, such as speed and storage capacity of a mobile phone. Firms use the data they can generate to convince consumers to purchase as part of an overall marketing approach. So it is with social or environmental results measurement. Buyers or financiers can then decide whether they want to pay for the service. The bottom line remains whether revenues exceed costs and profit can be made, because otherwise the activity will not occur or will not last.

That single bottom line is a measure of client satisfaction. When clients are voluntarily purchasing goods or services, even in monopolistic industries, profit can be made only if they value their purchase more than its cost. That is the old Adam Smith insight that serving people what they want is the way to profit and that the pursuit of self-interest is compatible with helping others. The success of any voluntary mechanism such as CSR, shared value investing, or impact investing—or whatever term might be used—is ultimately best measured by whether firms make profit that is sufficient to attract financiers. For social-minded equity financiers with low return expectations, it simply means that the cost of capital of the firm is lowered through a de facto “donation” by shareholders. As long as net income is sufficient to cover the cost of capital, the firm is doing well. Profit measures that. But that does not mean that profit is always a good measure for achieving social welfare or environmental success.

22. Shadow prices assign monetary values to positive or negative effects of firm behavior that are not priced in competitive markets, e.g. the cost of pollution

23. Norman and MacDonald (2004) point out that a real bottom line implies aggregation.

Profit may not capture all externalities, but it does capture whether voluntary initiatives are successful in persuading stakeholders to reward the firm monetarily for its efforts.²⁴

Limits of reputational mechanisms

Companies have incentives to behave well. A good reputation can lower costs, reduce threats of regulation, and keep employees happy and politicians at bay. But the incentive has limits, and how it relates to the best for society is not entirely clear.

Skewed incentives in policymaking

The way the threat of protest or regulation is generated reflects power relations in society that may or may not be good overall. Some stakeholders may hold excessive political power and might thus be favored unduly. The label of CSR may also help managers enhance autonomy from shareholder demands.

Managers may well respond favorably to labor demands that are supported by local politicians—to preserve ailing businesses in the name of job creation and responsibility to local communities. This favorable response may come at the expense of shareholders and actually prevent the creation of new and better jobs. But managers keep their jobs, gain prestige, and may be able to skew compensation.

Incentives in end games

The incentive to stick to commitments and maintain reputation suffers when key decision makers—for example, managers nearing retirement—have short-term horizons. Long-term compensation plans can mitigate this situation to a degree, but they are hardly perfect solutions. Particularly when firms have their back against the wall and face bankruptcy or liquidation, decision makers may happily suspend previous commitments. ENRON, for instance, voted several times to suspend its ethics rules, which were widely deemed to be “best in class.” When firms have lost all, perhaps due to shareholder-friendly gambles, fines can no longer be collected, and collateral may be worthless.

24. For profit to measure social and environmental externalities correctly, stakeholders would have to be willing to “donate” money to firms behaving responsibly. It is hard to see how people would know how much to contribute voluntarily and why some would not ride free on the efforts of others. For example, consumers would need to be willing miraculously to pay more for clean fuel in the amount that an appropriately set carbon tax would require.

4. *The Search for Credible Commitment Mechanisms*

We are thus left with the fact that firms are concluding contracts with all sorts of stakeholders, among them shareholders. Stakeholders need to assess how credible the firm is for the purpose at hand. Then they will decide whether to make firm-specific investments that are exposed to postcontractual opportunism or moral hazard.

The Challenge

Shareholders, for example, will form an impression of how much they can expect from the company. A company that credibly promises to maximize profit would be good for shareholders. But it could be bad for other stakeholders once they are tied to a firm.

The value of commitment

However, it helps shareholders when a firm can credibly commit to stakeholders in advance not to exploit them later. That simply means that sometimes shareholders should forgo a near-term opportunity to increase profit and instead support commitments to other stakeholders so that the long-term value of the firm is enhanced.

The decision makers in the firm — managers, board members, and controlling shareholders — are the ones who have to perform the balancing act. It is incumbent on them to commit to various undertakings in relation to all stakeholders with firm-specific investment. In this sense, a fiduciary duty to all stakeholders is actually good for shareholders as well.

The trouble with the profit motive

When the real bottom line of any firm is profit or the value of the firm to shareholders, then there is always suspicion that ex post greed may win out over commitment. By the same token it is fundamentally ambiguous whether firms behave well because they are “nice” or because they want to maximize profits. In the words of Oscar Wilde, this may be a case where the protagonists “know the price of everything and the value of nothing.”

In some sense the challenge is this: how can we make the firm inherently good so that in times of need it does not abandon its principles? This inherent goodness is not incompatible with making profit. To draw an analogy, Heidi Klum is making money because she is beautiful. Yet we clearly cannot say that she is beautiful because she wanted to make money — ignoring her efforts to keep in shape and preserve her natural beauty. Can we have firms that are both productive and intrinsically trustworthy — and see that achievement reflected in profit?

We should note that the key argument is not about being “good” but about being “trustworthy.” The issue is commitment, not a particular ethical behavior. Many commitment mechanisms discussed in this paper are also relevant for criminal groups. The Mafia, for example,

may benefit from austere rather than profit-seeking behavior by those arbitrating disputes (Gambetta 2009). Whether firms are perceived as ethically “good” or “bad” depends on the values of stakeholders.

Evolution has equipped humans with ways to assess the trustworthiness of others. Whole parts of the brain appear to have developed for that purpose (Ridley 1997). One part of “reading” others is an understanding of motives. As in criminology, a big part of an assessment of trustworthiness goes to motive, means, and opportunity. Firms have means and opportunity to exploit gaps in contracts and laws and to renege on commitments. The motive to do so is the search for profit. Hence all the standard elements are there for suspicion to be ripe.

Profit or greed occupies a prominent place among motives that make people suspect potential for foul play. Consider the extraordinary case of Harold Shipman, one of the most prolific serial killers. A doctor, he killed over 250 patients. Yet he was not caught until, for the first time, he sought to benefit monetarily and a victim named him in a will. Only then did the investigating authorities take allegations and patterns seriously.²⁵

Suppressing the Profit Motive: Nonprofit Firms

Taking the profit motive out of firms should reduce incentives to misbehave and help inspire trust.²⁶ That is the basic proposition behind all sorts of nonprofit firms.

The nondistribution constraint

Purely nonprofit firms do not distribute profits. They thus have no shareholders. They do, however, need capital and thus, at least initially, require donations instead of equity contributions. Therefore, the nonprofit form limits the ability to attract capital.

During operations, such firms do need to obtain a surplus of revenues over expenditures — that is, a profit — so as not to go bankrupt or wither away. Revenues may be obtained from sales or donations or a mix thereof. For example, many hospitals and nursing homes in the United States are incorporated as nonprofit entities but otherwise operate on a commercial basis with revenue entirely from paying patients. Other types of nonprofit agencies, such as charities of all types, make money mostly from donations. Apart from initial capital contributions, expansion of “commercial” nonprofit enterprises may be financed from retained earnings and debt.

Attracting donations and maintaining quality

In practice, incorporation as a nonprofit entity does seem to make a difference in how an organization deals with real or perceived incentives ex post to exploit stakeholders that have invested in firm-specific capital. Notably, donations flow almost entirely to nonprofit firms

25. For more on the Shipman case, see http://en.wikipedia.org/wiki/Harold_Shipman.

26. More fundamentally, critics of capitalism fear that the driver of capitalism, the profit motive, might undermine its very foundation, namely the ability to trust (Hirsch 1976).

and are a form of sunk, firm-specific investment. Once given, donated resources are in the custody of the receiving organization, and donors tend to have little control over them.

Donation essentially means that the payer for a good or service is a different person from the recipient. It is conceivable that donations may be made to for-profit firms as well. For example, when you buy your niece a book on Amazon.com and have it sent to her, you are paying for a service to someone else. We have no problem making this kind of “donation,” because the product is well-defined and it is easy to find out whether the niece received it as requested. For another example, TOMS Shoes has had some success selling shoes bundled with the promise to use a portion of the sales price to provide shoes “to a child in need.”²⁷ When paying for food for hungry children in a poor country, many charities try to match donors with a specific child and possibly have the child send a thank-you card. But typically donors are not so willing to make such donations to a for-profit charity, because the card ostensibly from the child may be a fake, as compared to the verifiable card from the niece for the book.

This is the challenge for impact investments or similar ventures that try to persuade equity investors to be content with substandard returns—a form of donation. The requirements for such organizations to measure with credibility the achievement of the social goal—and communicate it to investors—are formidable.²⁸ This has led Mohammed Yunus to argue that mixing profit distribution with social motivation in an enterprise is just a no-no (Yunus 2010).

Another area where nonprofit status helps inspire trust is commercial nonprofit enterprises. Nursing homes, for example, may have means and opportunity to shortchange elderly people once they have entered the home. Quality of care is notoriously hard to assess. It is also difficult for people to change nursing homes, because adjusting to any new environment may be stressful. Here again the nonprofit firm may help inspire trust for those who commit a substantial portion of their lives to a specific firm.

Questionable incentives for efficiency and productivity

However, not all nonprofit organizations inspire trust. Government agencies, for instance, are not favored destinations for donations, although some governmental organizations, such as UNESCO, manage to attract them. Some politicians or officials are as venal as any rogue for-profit firm, and sometimes nonprofit organizations are set up specifically to defraud donors. When the Ford Foundation announced in the 1980s in Nigeria that it was seeking to redirect its funds to nongovernmental organizations rather than making use of government channels, suddenly a number of NGOs sprang up, often backed by well-connected politicians.²⁹

27. For more information on TOMS Shoes, see http://www.toms.com/?cid=PS_5916337&gclid=CIThk5ie9bUCFdFT4AodtSQARA.

28. One new proposal is to make distribution of dividends a function of achievement of a social goal by some metric—less distribution occurs if and when the social goal is achieved (Chan 2011). It remains questionable whether measurement will be good enough to allow this method of distribution. It also remains unclear whether the proposal would work if dividends are not paid in all periods.

29. Personal communication to the author.

Some firms also may set up nonprofit entities to secure control over the firm. Since purely nonprofit organizations by definition have no shares,³⁰ such firms are protected against hostile takeovers. A number of large firms, such as Ikea, Krupp, and Bertelsmann, are owned by nonprofit foundations. The foundations may be set up to do good works, or they may, for example, provide for members of the founding family. Here the motive is not to attract donations but rather to escape the discipline of the market.

More generally, the absence of the profit motive reduces incentives to be efficient. Of course, nonprofit organizations need profit if they want to continue to operate and expand. Their managers and boards may be interested in expanding the organizations for all sorts of reasons, but there are no shareholders systematically advocating for cost-cutting or seeking out the highest return opportunities.

Eventually, nonprofit organizations that are run well may outcompete others, but there is little or no financial incentive to do so. For example, larger nonprofit entities may pay their managers high salaries as a way to attract qualified managers who have other good employment options. The head of the American Red Cross, for instance, used to earn over \$500,000 a year—a solid salary plus the ability to establish valuable connections and reputation. Many nonprofit agencies pay as well as governments or better. A recent *Time Magazine* article details the strong earnings performance of nonprofit organizations in the U.S. health-care system (Ford, et al. 2013).

This brings up another issue. Even if profits cannot be distributed to shareholders, they can be used to pay insiders more. Typically, therefore, nonprofit organizations need to convince donors or clients not only that they do not distribute profit to shareholders, but that they also do not abuse them in other ways. Nonprofit scandals thus revolve around excessive costs—salary levels, fundraising costs, and so on. A recent scandal in the United States concerns InfoCision, a telemarketing company used for soliciting donations. In one case the company was retained by the American Cancer Society. All donations mobilized were eaten up by InfoCision's costs, and the society had to make extra payments to it (Price 2012). Whether this was a matter of unintended bad luck or poor management is *prima facie* not clear. It could also be that greedy for-profit businesses, such as telemarketers, exploit lazy nonprofit organizations and deceptively abuse the trust of donors.

Incorporation as a nonprofit firm can thus help instill trust, but buyers (donors) still need to beware. As in any other enterprise, better results measurement can help establish trust. At the same time, incentives to provide misleading information also exist. When InfoCision worked for the American Diabetes Association, donors were assured that 75 percent of donations would

30. There are proposals (for example, by Mohammed Yunus) to create tradable shares in nonprofit firms (Yunus 2010)—a sound goal in principle, but it is hard to see how it would make sense in general and for his proposal in particular. He proposes two classes of shares. One is for shareholders that have provided an initial cash contribution to the firm. These shares could be sold in such a way that the owner would get back the nominal value of the principal but without any nominal return. The other type of shares would have no repayment rights. For shares without repayment rights there is no monetary incentive to pay. Why would anyone buy that share from another shareholder? It would make more sense to invest new money in the firm and thus get shares with repayment rights. The value of such shares depends on the expected nominal interest rate and the expected time of redemption of the initial contribution. Why would a holder of a share sell the share at a discount to the redemption rather than redeem?

go to the association. In fact, just 15 percent did. Given the limits to results measurement, there will continue to be significant opportunities to mislead donors.

There is thus no simple way to fix the constitution of firms in ways that render trustworthiness fully compatible with incentives to raise productivity. This reflects the basic dilemma of choosing a high-powered incentive system that may drive productivity versus a lower-powered incentive plan that not only limits incentives for ex post opportunism but also limits incentives to seek productivity improvements through either cost reductions or better goods and services (Laffont and Tirole 1993).

Commitment Devices

What is possible is the construction of various constraints on firms, which may be the best solution for certain classes of problems. Anyone who wants to attract donations is surely well-advised to consider incorporating as a nonprofit entity. A whole gamut of options exists to circumscribe the scope for high-powered incentives.

Circumscribing the profit motive

Distributions of profit can be limited, ranging from pure nonprofit firms to limited-dividend companies that cap returns on equity. Other ways of distributing profits can be tackled by limiting wage levels or through other cost controls. Profit distribution may also be limited to certain people. For example, cooperatives allow profit distribution to customers of the firm. Shareholding may also be restricted to employees of a firm.

Structuring decision making

Boards may be composed in different ways. To strengthen the power of shareholders, for example, it may help to have directors who are independent of management. In principle, various types of stakeholders could also be represented on boards. In Germany, employees are represented on the supervisory board (Aufsichtsrat). The practical difficulty is determining which stakeholders to recognize and who does and does not get represented, because representing all different stakeholder interests on boards would be a recipe for gridlock. Instead, to represent current stakeholders better, it may make sense for directors to have a duty to all stakeholders instead of just to shareholders. An example is the rule in the United Kingdom that forbids directors to carry out wrongful trading when a company is insolvent. This is to prevent shareholders and managers from gambling at the expense of creditors.

It would also be possible to tie different voting rights to different types of shareholders. A much-discussed set of plans tries to tie voting rights to shareholders who are deemed to have long-term interests in a firm. This may be achieved by creating several classes of shares.³¹ Some shares may not be tradable (“locked in”) for lengthy periods but carry voting rights. Others might be liquid and carry no voting rights. This is supposed to provide incentives for locked-in shareholders to scrutinize information more diligently and to reduce their incentive to

31. The Google case is a recent high-profile example of this approach.

mislead others about the long-term prospects of the firm. The key is that locked-in controlling shareholders, by definition, sell only rarely. The incentive to mislead at the time of a sale — the classic lemons problem mentioned earlier — may thus arise less frequently.

5. *The Way(s) Forward*

For-profit and nonprofit organizations have been around for over two centuries now. Nonprofit enterprises often benefit from tax or regulatory advantages. The question arises: if they are superior to for-profit firms and sometimes receive such extra benefits, why have they not taken the world by storm? Limited-dividend firms have made very little headway.

The Historical Verdict, So Far

The fate of early utopian experiments may be instructive. Rosabeth Moss Kanter of the Harvard Business School wrote her doctoral dissertation on utopian societies (Kanter 1972). Few survived. Those that did survive tended to split into regular forms of organizations: Commercial operations survived when transformed into joint-stock companies; today's Amana appliances company is one such survivor. Other parts of the organizations became municipalities or churches.

The profit motive

On balance, the search for profit has been an essential element of productivity growth. For-profit firms are superior organizational forms and underpin the extraordinary wealth creation the world has seen over the last 200 years. The Harold Shipman case, as noted earlier, illustrates that questionable motives other than the search for profit exist, even when they are not obvious. In a way, the for-profit firm thus exhibits more “truth in advertising” than other, more murky endeavors. The very fact that the profit motive is out in the open may draw greater scrutiny, which can at least to some extent offset any bad incentives.

However, a key issue is whether firms with a profit motive can maintain sensible commitments that are in the interest of all stakeholders, including shareholders. Some people argue that mandating board members to look only after shareholder interests (subject to contracts, laws, and regulations) weakens incentives to pursue long-term value creation; they attribute this weakness to a mixture of excessive ex post opportunism toward stakeholders and the generation of misleading information that hides unwarranted risks. Colin Mayer (2013) argues that the decline of British industry and its small and medium enterprises and the disproportionate expansion of financial services in Great Britain are driven by the country's exceptionally strong legal mandate for boards to represent only shareholders. Others argue that eventually shareholder-driven firms will come to be the most successful form of firms (Hansmann and Kraakmann 2000), essentially because they would be able to attract capital at lower cost and thus outperform other firms—all else being equal. In arguing this, Hansmann and Kraakmann make the assumption that stakeholders other than shareholders are adequately protected by contracts.

Governance models and product market competition

In practice we observe that a variety of governance arrangements for firms exists around the world. As times change, different types of firms seem to be doing well, at least for a while, notably U.S., German, Japanese, and now maybe Chinese firms, including state-owned ones. Governance arrangements for all these firms vary substantially and also overlap across countries. It is not obvious which set of arrangements is best. Views vary substantially about whether firms should serve primarily shareholders or all stakeholders. In the United States and the United Kingdom, shareholder-rights views dominate. In France, Germany, and Japan, stakeholder balance is considered most important.

What seem not to work well are systems relying entirely on protected state-owned firms or on worker-owned firms such as those in the former Yugoslavia. Many state-owned Chinese firms are exposed to strong product market competition and may thus de facto behave like a “model” private firm without effective protection against competition—similar to the performance of protected Japanese and Korean firms that were exposed to export market competition. In general, product market competition appears to be critical for the success of firms: there needs to be an effective threat of entry and exit. When firms are shielded from such competition, they enjoy monopoly powers and tend to stand in the way of productivity growth and efficiency, even when shareholder rights protection is strong. Highly protected firms in Japan and Korea have fallen behind in productivity growth, resulting in a dual economy in which some firms are global leaders and others are clearly lagging.

Laws and reputation

As sketched above, corporate governance mechanisms are determined by legal or regulatory provisions that vary from country to country. Cross-country comparisons of corporate governance show clear differences in the legal framework as well as clear effects on corporate structure and the value of firms (Shleifer and Vishny 1997). In countries with weak shareholder protections, external equity finance tends to be limited, family firms and conglomerates rely heavily on internal finance, and the value of firms quoted on public markets tends to be lower than that of firms with similar cash flow in markets where shareholders are better protected.

Yet the law does not seem all-important. For example, firms in the United Kingdom were able to attract just as large a share of external finance in the 19th century and early 20th century, when legal shareholder protections were weak, as they do now (Franks et al. 2003). Quoted firms in emerging markets are able to finance themselves with higher shares of equity relative to retained earnings than firms in developed markets (Singh 1995). Firms in China attracted capital, including from foreign investors, when legal protections were clearly weak. Strong growth may have made it possible to pay investors relatively easily, and the expectation of growth may have reinforced incentives to behave well and maintain access to new funding.

It seems that the interest in preserving a good reputation as a way to maintain access to future financing opportunities is after all a powerful force—withstanding the scope for some degree of ex post opportunism. Despite weaknesses in legal protection and despite recurring corporate scandals, overall the interest in maintaining reputation has provided an important

incentive that has sustained commitment in many cases. At the same time, legal and regulatory reforms are important to the extent that they may over time improve systems beyond what can be sustained by reputational incentives alone. In some sense the point is obvious: the world has not evolved by first setting up perfect legal frameworks and then allowing systems to develop; innovations in the financing of firms occurred and went hand-in-hand with legal development — with innovations in both areas egging each other on.

In sum, what seems to be important is a clear role for the profit motive, and thus shareholder rights, albeit one that is linked to a way of sustaining commitments to other stakeholders. Probably even more important is a reliance on product market competition. Steady improvements in legal and regulatory frameworks are likely to help, and the mix of arrangements varies by jurisdiction precisely because of the importance of the law. There is thus little hope of determining which type of corporate governance is best, based purely on competition between different forms. The whole package of policies and institutions governing the behavior of firms matters. This makes a form of competition among jurisdictions possible — and useful.

Openness to Innovation

There may be some very general principles for what constitutes good corporate governance, such as predictability and transparency. The OECD (Organisation for Economic Co-operation and Development) Principles of Corporate Governance contains such ideas and reflects a compromise acceptable, in principle, to all OECD member countries, spanning the range from the United States to Japan (OECD 2004).

At the same time, any law that enshrines particular practices may make future innovation difficult, because it tends to build political constituencies in favor of the law (Rajan and Zingales 2003). To some degree, openness to innovation may be preferable to detailed rules. Thus there is no clear indication that the law should prescribe a particular set of corporate governance principles. Instead the law should leave options open for firms to choose different mixes of governance mechanisms.

However, it may make sense for governments to provide various standard forms of incorporation and the requisite enforcement system, to make it easier for investors to understand the bundle of rights and obligations that they assume when investing. Such an approach to corporate governance principles de facto cherishes sociodiversity and establishes a climate for the forces of evolution, driven by competition among jurisdictions, to provide further clarity about which firms perform best in what context. In practice, many governments pursue variants of this route — for example, multiple stock exchanges with different listing requirements. Most jurisdictions including the United States also allow various mechanisms that, for instance, restrict voting rights to certain classes of shareholders. In the United States, Google provides a recent high profile example of opting for such a share structure.

Technical and organizational innovations lie behind the extraordinary wealth creation of the modern era. The firm itself is such an organizational innovation — a powerful mechanism for enabling people to work together and to establish commitment that extends beyond any

human lifetime. Because such commitment is independent of the people who work in a firm at any particular time, firms can undertake—and succeed with—endeavors that groups of individuals could not even hope to tackle. By the same token, we should not reduce the scope for additional organizational innovation but rather be open to further organizational experiments. But a note of caution: Where openness to experimentation reigns, financiers and other stakeholders ultimately have to beware. Not all risks can—or should—be eliminated. And not all firms behave nicely.

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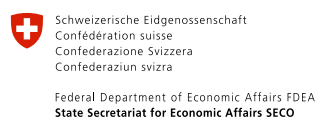
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