

**Corporate Governance for the Common Good:  
Economic Equality Requires Investment in Productive Capabilities**

**Memo for the Conference on  
Labor, Technology and Growth: Towards A Gini Negative Solution**  
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### ***The Investment Triad and the Productive Economy***

A prosperous society requires an economy that can generate stable and equitable growth—or what I call “sustainable prosperity.” Productivity *growth* makes possible higher living standards for the population. Employment *stability* enables individuals to remain productive for the decades of their working lives and may also provide them with savings for years or even decades of retirement. Income *equity* distributes the society’s productivity fairly among those who contribute their work efforts and financial resources to generating that productivity, while ensuring the sustainability of the planet’s natural environment.

Since the 1980s, however, the U.S. economy has experienced unstable employment, inequitable income, and sagging productivity, with a degradation of the natural environment. There has been an erosion of employment opportunities that support upward socioeconomic mobility in a nation that once professed to be the land of a prosperous middle class. There has been an increasing concentration of income among the very richest households, reversing a trend toward somewhat more income equality in the decades after World War II. And in a world of rapid technological change the United States has been experiencing slow productivity growth as its major business corporations lag their global competitors in such vital areas as alternative energy, communication infrastructure, and life-saving medicines.

Sustainable prosperity requires *investment in productive capabilities* that can generate goods and services that are higher quality and lower cost than those that had previously been available, thus creating the productivity growth that, depending on how it is distributed, can deliver higher living standards to masses of people. Household units, governments agencies, and business firms invest in productive capabilities. These organizations, working together as the “investment triad,” are the social foundations of a productive, and hopefully prosperous, economy.

*Household units* invest in the education of the young with a view to providing them with the knowledge that they will need to function as productive adults, who will then use the income from productive employment to have families of their own. Critical determinants of household investments in productive capabilities are the relation between spouses or partners as care providers and income earners, the quality of education that the young are able to receive, and the number of years over which they receive their educations. A productive economy needs household units that, by investing in the future labor force, function as *supportive families*.

*Government agencies* enable investments in productive capabilities by household units by providing schooling at the primary, secondary, and tertiary levels that most households, each acting on its own, could not afford. As a critical component of investment in productive capabilities, government agencies are involved in providing services for public and personal health. Government agencies can also be charged with investing in the creation, through basic and applied research, of new knowledge that would otherwise not come into existence. In addition, we rely on government agencies to invest in physical infrastructure such as transportation, communication, energy, water, and waste systems. A productive economy needs government agencies that, by investing in knowledge and infrastructure, function as *developmental states*.

*Business firms* make use of the knowledge and infrastructure provided by government agencies and the human capabilities provided by household units as foundations for making firm-specific investments in human and physical capabilities that can generate goods and services that these businesses can sell on product markets. For productivity growth to occur, a good or service must be higher quality and/or lower cost than the product previously available on the market. A productive economy needs business firms that, by generating higher-quality, lower-cost products, function as *innovative enterprises*.

Sustainable prosperity requires the triadic interaction of the investment strategies of supportive families, developmental states, and innovative enterprises. Households and governments interact through

investments in education. Governments and businesses interact in the development of the high-tech knowledge base. Businesses and households interact through the employment relation. The quality of these interactions in the development and utilization of productive capabilities is of critical importance to the potential productivity of resources that are invested in the business firm as well as the distribution of the firm's productivity gains through employment and remuneration.

The business firm can provide adults in households with employment that, with sufficient productivity, may enable them to support their families. Through formal training and on-the-job experience, a firm also invests in the knowledge of some or all of the people whom it employs. The firm then has an incentive to retain these productive people. It generally does so through pay increases and promotions to jobs that require superior functional capability and greater hierarchical responsibility. It is primarily through in-house pay increases and promotions for valued employees in stable employment relations in innovative enterprises that households' living standards increase over time, giving rise to the "middle class."

In high-tech fields, firms make specialized investments in in-house capabilities to absorb and further develop the advanced knowledge that investments by government agencies have created. In many cases, government agencies make strategic investments in knowledge-creation through business firms in the form of research contracts and subsidies. And more fundamentally, it is through decades of on-the-job experience in business firms as well as government agencies that masses of individuals, building on their formal educations, accumulate the productive capabilities that enable them to contribute to the innovation processes that can result in productivity growth.

### ***Innovative Enterprise and the Growth of the Firm***

In short, we depend upon the investment triad to put in place the productive capabilities essential to a prosperous economy. The affordability of these investments in productive capabilities requires the *utilization* of the knowledge and skills that these investments have developed. For the utilization of this knowledge base, we rely primarily on its employment by business firms that, to survive, must produce the higher quality, lower cost goods and services that can compete on product markets, typically on a global scale. Sustainable prosperity requires innovative enterprise.

Innovation processes are uncertain, collective, and cumulative. As a result, innovative enterprise depends on three *social conditions*: strategic control, organizational integration, and financial commitment. *Strategic control* empowers executives who, facing technological, market, and competitive uncertainties, have the abilities and incentives to invest in innovation by allocating the firm's resources to innovative strategies. *Organizational integration* mobilizes large numbers of people with various hierarchical responsibilities and functional specialties to contribute their skills and efforts to the collective learning processes that are the essence of innovative enterprise. *Financial commitment* sustains cumulative learning processes that transform technologies and access markets from the time at which investment in innovation is made until the generation of a higher-quality, lower-cost product can yield financial returns.

Innovative enterprise results in the growth of the firm. In industries that require high fixed-cost investment in organization and technology to generate innovative products, firms that innovate tend to grow large. For over a century very large firms have dominated the U.S. economy. The most recent census data show that in 2016, 1,046 companies that had 10,000 or more employees in the United States, with an average workforce of 35,157, were only 0.017% of all U.S. businesses, but had 10% of all establishments, 29% of employees, 33% of payrolls, and an estimated 37% of all revenues. For 2,102 companies with 5,000 or more employees in 2016, these shares were 12% of establishments, 35% of

employees, 40% of payrolls, and an estimated 46% of revenues.<sup>1</sup> The productive capabilities and product demand available to vast numbers of smaller firms depend on the development and utilization of productive capabilities by these largest companies. How these ultra-large companies allocate the resources under their control has profound implications for employment opportunity, income distribution, and productivity growth in the United States.

One needs a theory of innovative enterprise to analyze the growth of the firm. A firm can grow large relative to the size of its industry by investing in organizational learning that generates a higher quality product than those that are available from competitors. These investments entail, first and foremost, the high fixed cost of the learning organization, with the amount of the fixed cost being determined by both the size of investments at points in time and the duration of the investments from the time that they are made until, through the sale of a higher-quality, lower-cost product, the firm can generate financial returns. The possession of a higher-quality product gives the firm a competitive advantage in capturing a large extent of the market, enabling the firm to transform high fixed cost into low unit cost through reaping economies of scale. Indeed, in some industries, the cost of accessing the market by making a product readily available to buyers and convincing them that the product is actually higher quality entails a higher fixed cost than that required for the transformation of the technologies embodied in the product.

When an innovative enterprise has succeeded in generating a higher-quality, lower-cost product, it can engage in “administered” pricing because the price that it can charge for its product is not set by market competition. The pricing of the product becomes a strategic variable, conditioned by the product’s price elasticity of demand and the capability of the firm to expand sold output without an erosion in product quality, which itself typically requires process innovation. It is erroneous, however, to assume that the price that the innovating firm chooses will reflect monopolistic rent-seeking. Given its unique capability to achieve economies of scale, the innovative enterprise may reap higher profits than its un-innovative competitors even as it charges a lower price and provides expanded output to the buyers of its product.

Furthermore, by influencing profits, pricing can have a key influence on the social condition of innovative enterprise that I call “financial commitment.” Once a firm becomes profitable, the profits that it generates and retains become the financial foundation for rewarding workers in the form of pay, benefits, and continued employment as well as reinvesting in the productive capabilities that enable the firm to engage in product and process innovation. I call this mode of corporate resource allocation “retain-and-reinvest”: the firm retains its profits and people and reinvests in productive capabilities that can enable it to engage in a new round of innovation. By keeping people employed, rewarding them for their prior contributions to value creation, and re-engaging in innovation for the future, retain-and-reinvest tends to contribute to stable and equitable economic growth.

### ***From Innovation to Financialization***

A retain-and-reinvest regime depends on the abilities and incentives of those executives who exercise strategic control over the allocation of corporate resources. These senior executives must have the abilities to envision the investment strategies that can generate the next round of innovative processes and products. These senior executives must also have the incentives to return value to the firm’s employees, suppliers, and distributors while reinvesting in inherently uncertain innovation strategies that can sustain the company as a productive business firm in the years to come.

Whether senior executives who exercise strategic control possess the abilities and incentives to retain-and-reinvest is a matter of corporate governance. Such innovative behavior cannot be assumed. The very

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<sup>1</sup> United States Census Bureau, “2016 SUSB Annual Data Tables by Establishment Industry,” December 2018, at <https://www.census.gov/data/tables/2016/econ/susb/2016-susb-annual.html>. The latest data on firm size for 2016 do not include revenues (collected only every five years). I have estimated 2016 revenues, extrapolating from previous years’ data.

existence of the profits of innovative enterprise may incentivize those who exercise strategic control to enrich themselves by extracting value from the firm instead of sharing these gains with workers whose value-creating skills and efforts helped to generate these profits. Rather than retain-and-reinvest, these executives may engage in “downsize-and-distribute”: they may downsize the labor force by pressing down wages and laying off employees, while possibly also selling corporate assets and taking on corporate debt, for the purpose of distributing more cash to shareholders in the form of dividends and stock buybacks.

Senior executives of major U.S. corporations have been incentivized to engage in downsize-and-distribute by stock-based pay that rewards them for giving manipulative boosts to the company’s stock prices, with the realized gains from the exercise of stock options and the vesting of stock awards going into their personal bank accounts. For each year from 2006 through 2018, the average annual remuneration of the 500 highest-paid U.S. corporate executives ranged from a low of \$15.9 million in 2009, of which 60% was stock-based, to a high of \$34.0 million in 2015, of which 83% was stock-based.<sup>2</sup> I have argued that, given these stock-based incentives to extract value through a downsize-and-distribute allocation regime, senior executives will lose the ability—assuming they had it in the first place—to envision the types of investments in organizational learning required to engage in innovation.

Dividends are the traditional way in which a company provides a yield to shareholders for, as the name says, holding the shares. Coming into the 1980s, there were discussions in boardrooms, business schools, and the business press that the dividend payout ratios of U.S. industrial corporations were too high, given the need for reinvestment of profits to meet the new challenges of global competition. Then in November 1982, the U.S. Securities and Exchange Commission (SEC), which had been launched in the mid-1930s to mitigate fraud and manipulation on U.S. financial markets, adopted Rule 10b-18, which gives corporations a “safe harbor” against manipulation charges in doing stock buybacks as open-market repurchases as long as, along with other stipulations, the amount repurchased on any given trading day does not exceed 25% of the stock’s average daily trading volume (ADTV) over the previous four weeks. For the five largest repurchasers over the decade 2009-2018, the 25%ADTV limits in October 2019 were Apple \$1.6 billion, Exxon Mobil \$166 million, Microsoft \$754 million, Oracle \$183 million, and IBM \$125 million—and they could repurchase these amounts trading day after trading day. In effect, with the promulgation of Rule 10b-18, the SEC transformed itself from a regulator to a promoter of the stock market. In a forthcoming paper, Ken Jacobson and I call SEC Rule 10b-18 “a license to loot.”

Dividends distributed by the 222 companies in the S&P 500 Index in January 2019 that were publicly listed for the years 1981 through 2018 were 49.8% of profits in 1981-83 and 52.3% in 2016-18. Buybacks distributed by these same 222 companies were just 4.5% of profits in 1981-83—before the impact of Rule 10b-18—but 63.5% in 2016-18. The vast increase in stock buybacks under Rule 10b-18 has been in addition to, not instead of, dividends, with buybacks first surpassing dividends in the U.S. corporate economy in 1997. Buybacks are much more volatile than dividends over the boom and bust of the stock market, with most buybacks being done when stock prices are high. Whereas one gets a dividend for holding shares, stock market traders gain from buybacks by timing the buying and selling of shares, with a company’s senior executives, hedge-fund managers, and Wall Street bankers being best positioned as *sharesellers* to engage in this type of value extraction.

In our recently published book, *Predatory Value Extraction*, Jang-Sup Shin and I show how the combination of corporate executives as value-extracting *insiders*, asset fund managers as value-extracting *enablers*, and hedge-fund activists as value-extracting *outsiders* have enriched themselves through this legalized

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<sup>2</sup> Note that almost all of the figures on executive pay reported in the press and used even by most progressive groups that are critical of outsized executive pay are fictional “fair value” numbers based on grant date stock-price valuations of stock options and stock awards, with the formula for valuing stock options being based on Black-Scholes-Merton option-pricing models, which assume away the extreme volatility in stock prices that can yield large realized gains. Fair value data should not be used.

looting of the U.S. business corporation. In particular, corporate executive and hedge-fund managers have extracted far more value for themselves relative to their contributions (if any) to the value-creation processes that generated corporate profits. The distributions to shareholders have been massive. For the 465 companies in the S&P 500 Index in January 2019 that were publicly listed from 2009 through 2018, buybacks were \$4.3 trillion, representing 51.5% of profits, and dividends \$3.3 trillion, another 39.3% of profits. As I put it in the subtitle of my 2014 *Harvard Business Review* article, “Profits Without Prosperity,” stock buybacks manipulate the market and leave most Americans worse off.

In a large and growing body of research that focuses on particular industries and companies, my colleagues and I have shown when and how a downsize-and-distribute resource-allocation regime results in unstable employment, inequitable income, and sagging productivity.<sup>3</sup> For example, in the pharmaceutical industry, U.S. taxpayers provide \$30-\$40 billion per year for life-sciences research that is made available to the drug companies. In addition to 20-year patents, the U.S. government also provides drug companies with market protection and subsidies under the Orphan Drug Act of 1983. Since the 1980s the U.S. pharmaceutical industry has lobbied against government regulation of drug prices, arguing that its member companies reinvest the high profits from high prices in drug innovation. Our research documents, however, that from 2009 through 2018, the 18 pharmaceutical companies in the S&P 500 Index spent \$335 billion on buybacks and \$287 billion on dividends, which together represented 106% of their profits.

The companies have in fact been using high drug prices to boost their stock prices—to the benefit of the pharmaceutical executives’ pay packages. Indeed, for the decade, distributions to shareholders were 14% greater than the \$544 million that these 18 pharmaceutical companies spent on R&D. In the presence of financialization, much if not most of that R&D spending has failed to result in drug innovation, explaining the widespread complaint of a “productivity crisis” in the U.S. pharmaceutical industry. Our research reveals that while large U.S. pharmaceutical companies such as Merck and Pfizer have been abusing the U.S. national innovation system by allocating the gains that they derive from it to do buybacks and dividends, certain non-financialized European companies—most notably Swiss-based Roche—have been making use of the U.S. system to become global leaders in drug innovation.

### ***The Fallacy of Maximizing Shareholder Value***

Since the 1980s, economists known as agency theorists have justified stock buybacks and the stock-based executive pay that incentivizes them by arguing that the maximization of shareholder value (MSV) at the corporate level contributes to the most efficient allocation of resources in the economy as a whole. In the words of Michael Jensen, the leading agency-theory proponent of MSV in the 1980s and 1990s, companies should “disgorge” their “free cash flow” to the stock market so that these financial resources can be allocated to their most efficient alternative uses. The term “disgorge” implies that the profits that a company has accumulated have been captured illegitimately, undermining the role of financial markets in the efficient allocation of the economy’s resources. The term “free” implies that cash flow that is not needed to maintain capital equipment can be distributed to shareholders without harming the business as a going concern. Hence if a company can layoff, say, 1,000 employees, it can increase its “free” cash flow, to be “disgorged” to shareholders in the form of buybacks and dividends. As “agents” of the firm’s “principals”—who are assumed to be its shareholders—corporate executives should be incentivized to (using my term) downsize-and-distribute through stock-based pay that aligns their incentives with the company’s shareholders.

The MSV view assumes that, with the exception of shareholders, the “market economy” rewards all other participants in the firm with a *guaranteed market return* for their productive contributions. It is assumed

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<sup>3</sup> See <https://www.ineteconomics.org/research/experts/wlazonick>, and <https://hbr.org/search?term=william+lazonick>.

that, lacking a market-guaranteed return, only shareholders bear the risk of whether the firm incurs a profit or loss. Hence, it is only shareholders who, as risk-bearers, have a claim on profits if and when they occur. It follows that, as the sole risk-bearers, shareholders will be the only economic actors who have an interest in allocating the “free” cash flow that the firm “disgorges” to its most efficient alternative uses. Hence, agency theorists argue, the maximization of shareholder value results in the allocation of the economy’s resources to their most efficient uses.

For lack of a theory of innovative enterprise, the MSV view of how the economy functions and performs is fundamentally flawed. The most basic error is the assumption that *public shareholders invest in the productive assets of the corporation*. They do not. They allocate their savings to the purchase of shares that are outstanding on the stock market, and they are willing to do so because, with limited liability, the liquidity of the stock market enables them to sell those financial assets virtually instantaneously at any time they so choose, thus mitigating their risk. Moreover, public shareholders cannot allocate financial resources to their most efficient uses because it requires investment in innovative enterprise to bring the “most efficient use” into existence. As a form of private equity, venture capital can play this value-creating role, but for venture capital an initial public offering on the stock market is an *exit* strategy. MSV ideology is flawed because the stock market is primarily an institution for value extraction, and not for value creation as is commonly believed.

In contrast to the lack of value-creating contributions by public shareholders, in working hard and smart to create value for the company, embodied in its competitive products, *workers* take the risk that the innovation strategy of the firm will be unsuccessful, resulting in the need for pay cuts or layoffs for the firm to stay afloat. Workers also bear the risk, as has been borne out in practice, that when profits that can sustain their employment and enhance their pay are generated, predatory value extractors will invoke MSV ideology to lay claim to those profits, thus depriving workers of the financial foundation for stable and equitable economic growth.

Similarly, households as *taxpayers* bear risk when they fund investments by government agencies in infrastructure and knowledge, of which business firms make use. If the firms do not generate profits, households as taxpayers lose corporate tax revenues, for a given tax rate. Worse yet, as happened for example with the Tax Cuts and Jobs Act of 2017, taxpaying households bear the risk that predatory value extractors will convince the government to lower corporate tax rates, purportedly to stimulate investment in productive capabilities and then use the increased profits to do more distributions to shareholders for the sake of a higher stock price.

### ***Corporate Governance for Sustainable Prosperity***

There are five changes in the U.S. institutional environment that can transform corporate governance so that it supports the attainment of stable and equitable economic growth:

1. Make stock buybacks done as open-market repurchase a potential manipulation of the stock market by rescinding SEC Rule 10b-18 (a course of action that is integral to U.S. Sen. Tammy Baldwin’s Reward Work Act, reintroduced as Congressional legislation in March 2019).
2. Change the structure of executive pay so that it incentivizes retain-and-reinvest rather than downsize-and-distribute.
3. Fix the system of corporate taxation so that it rewards value creation and penalizes value extraction.
4. Place representatives of value creators—particularly workers and taxpayers—on corporate boards, while excluding predatory value extractors from these positions.
5. Through government-business collaboration for investment in productive capabilities, reinvigorate the investment triad so that it supports the “collective and cumulative” careers that are essential to upward socioeconomic mobility and a flourishing middle class.