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Maximizing shareholder value: a new ideology for corporate governance

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Abstract

The decade-long boom in the US stock market and the more recent boom in the US economy have fostered widespread belief in the economic benefits of the maximization of shareholder value as a principle of corporate governance. In this paper, we provide an historical analysis of the rise of shareholder value as a principle of corporate governance in the United States, tracing the transformation of US corporate strategy from an orientation towards retention of corporate earnings and reinvestment in corporate growth through the 1970s to one of downsizing of corporate labour forces and distribution of corporate earnings to shareholders over the past two decades. We then consider the recent performance of the US economy, and raise questions about the relation between the maximization of shareholder value and the sustainability of economic prosperity.

Keywords: shareholder value; corporate governance; corporate strategy; US economy.

Introduction

Over the past two decades the ideology of shareholder value has become entrenched as a principle of corporate governance among companies based in the United States and Britain. Over the past two or three years, the rhetoric of shareholder value has become prominent in the corporate governance debates in European nations such as Germany, France and Sweden. Within the past year,

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the arguments for 'maximizing shareholder value' have even achieved prominence in Japan. In 1999 the OECD issued a document, *The OECD Principles of Corporate Governance*, that emphasizes that corporations should be run, first and foremost, in the interests of shareholders (OECD 1999).

But what does 'maximizing shareholder value' mean? Is it an appropriate principle for the governance of corporations in the advanced economies in the twenty-first century? Does the implementation of this principle improve the competitive performance of corporate enterprises? Would the reform of the continental European and Japanese systems of corporate governance based on the principle of maximizing shareholder value bring sustainable prosperity to these economies?

In the so-called Anglo-Saxon economies of the United States and Britain, the exclusive focus of corporations on shareholder value is a relatively recent phenomenon, having risen to prominence in the 1980s as part and parcel of the Reaganite and Thatcherite revolutions. The decade-long boom in the US stock market and the more recent boom in the US economy have impressed European and Japanese corporate executives with the potential of shareholder value as a principle of corporate governance, while American institutional investors, investment bankers and management consultants have incessantly promoted the virtues of the approach in Europe and Japan.

There is, however, in both Europe and Japan, considerable misinformation about why shareholder value has become so prominent in the governance of US corporations over the past two decades and the actual impact of its implementation on the performance of US corporations and the US economy. Therefore, as a precondition for considering the arguments for 'maximizing shareholder value' in those nations in which it is not yet an entrenched principle of corporate governance, it is imperative that we understand the evolution and impact of the quest for shareholder value in the United States over the past two decades. Such is the purpose of this paper.

The origins of 'shareholder value'

The arguments in support of governing corporations to create shareholder value came into their own in the United States in the 1980s. As has been the case throughout the twentieth century, in the 1980s a relatively small number of giant corporations, employing tens or even hundreds of thousands of people dominated the economy of the United States. On the basis of capabilities that had been accumulated over decades, these corporations generated huge revenues. They allocated these revenues according to a corporate governance principle that we call 'retain and reinvest'. These corporations tended to retain both the money that they earned and the people whom they employed, and they reinvested in physical capital and complementary human resources. Retentions in the forms of earnings and capital consumption allowances provided the financial foundations for corporate growth, while the building of managerial organizations to develop and utilize productive resources enabled investments in plant, equipment and personnel to succeed (Ciccolo and Baum 1985; Hall 1994; Corbett and Jenkinson 1996).

In the 1960s and 1970s, however, the principle of retain and reinvest began running into problems for two reasons, one having to do with the growth of the corporation and the other having to do with the rise of new competitors. Through internal growth and through merger and acquisition, corporations grew too big with too many divisions in too many different types of businesses. The central offices of these corporations were too far from the actual processes that developed and utilized productive resources to make informed investment decisions about how corporate resources and returns should be allocated to enable strategies based on 'retain and reinvest' to succeed. The massive expansion of corporations that had occurred during the 1960s resulted in poor performance in the 1970s, an outcome that was exacerbated by an unstable macroeconomic environment and by the rise of new international competition, especially from Japan (Lazonick and O'Sullivan 1997; O'Sullivan 2000: ch. 4).

Japanese competition was, of course, particularly formidable in the mass-production industries of automobiles, consumer electronics and in the machinery and electronic sectors that supplied capital goods to these consumer durable industries. Yet these had been industries and sectors in which US companies had previously been the world leaders and that had been central to the prosperity of the US economy since the 1920s.[1] Japan was able to challenge the United States in these industries because its manufacturing corporations innovated through the development and utilization of integrated skill bases that were broader and deeper than those in which their American competitors had invested (Lazonick 1998). Compared with American practice, Japanese skill bases integrated the capabilities of people with a broader array of functional specialties and a deeper array of hierarchical responsibilities into processes of organizational learning. In particular, the hierarchical integration of Japanese skill bases extended from the managerial organization to shop-floor production workers and subsidiary firms that served as suppliers and distributors. In contrast, US companies tended to use their managerial organizations to develop and utilize technologies that would enable them to dispense with shop-floor skills so that 'hourly' production workers could not exercise control over the conditions of work and pay. US companies also tended to favour suppliers and distributors who would provide goods and services at the lowest price today, even if it meant that they were not engaged in innovation for tomorrow (Lazonick and O'Sullivan 1997).

As, during the 1970s, major US manufacturing corporations struggled with these very real problems of excessive centralization and innovative competition, a group of American financial economists developed an approach to corporate governance known as agency theory. Trained, as virtually all American economists are, to believe that the market is always superior to organizations in the efficient allocation of resources, these economists were ideologically predisposed against corporate – that is, managerial – control over the allocation of resources and returns in the economy. Agency theorists posited that, in the governance of corporations, shareholders were the principals and managers were their agents. Agency theorists argued that, because corporate managers were undisciplined by the market mechanism, they would opportunistically use their control over the allocation of corporate resources and returns to line their own pockets, or at least to pursue objectives that were contrary to the interests of shareholders. Given the entrenchment of incumbent corporate managers and the relatively poor performance of their companies in the 1970s, agency theorists argued that there was a need for a takeover market that, functioning as a market for corporate control, could discipline managers whose companies performed poorly. The rate of return on corporate stock was their measure of superior performance, and the maximization of shareholder value became their creed (see, for example, Ross 1973; Jensen and Meckling 1976; Fama and Jensen 1983; Jensen 1986; Scharfstein 1988; Baker *et al.* 1988).

In addition, during the 1970s, the quest for shareholder value in the US economy found support from a new source – the institutional investor.[2] The transfer of stockholding from individual households to institutions such as mutual funds, pension funds and life insurance companies made possible the takeovers advocated by agency theorists and gave shareholders much more collective power to influence the yields and market values of the corporate stocks they held. During the 1950s and 1960s, there were legal restrictions on the extent to which life insurance companies and pension funds could include corporate equities in their investment portfolios, while mutual funds played only a limited, although growing, role in the mobilization of household savings. In the 1970s, however, a number of changes occurred in the financial sector that promoted the growth of equity-based institutional investing. Partly as a consequence of Wall Street's role in the buying and selling of companies during the conglomeration mania of the 1960s, from the early 1970s there was a shift in the focus of Wall Street financial firms from supporting long-term investment activities of corporations (mainly through bond issues) to generating fees and capital gains through trading in corporate and government securities. To expand the market for securities trading, Wall Street firms convinced the Securities and Exchange Commission (SEC) to put an end to fixed commissions on stock exchange transactions. At the same time, developments in computer technology made it possible for these firms to handle much higher volumes of trade than had previously been the case.

Meanwhile, the oil-induced inflation of the 1970s created a problem for US financial institutions in managing their financial assets to generate adequate returns, thus leading to the financial deregulation of the American economy. As investors in stocks and bonds, mutual funds had advantages over other institutional investors such as life insurance companies and pension funds in generating higher returns on household savings because they were not subject to the same stringent regulations concerning the types of investments that they could make. Moreover, even without the mutual funds as competitors, the inflationary conditions of the 1970s meant that, under current regulations, pension funds and insurance companies could no longer offer households positive real rates of return. The regulatory response was ERISA – the Employee Retirement Income Security Act (1974) – which, when amended in 1978, permitted pension funds and insurance companies to invest substantial proportions of their portfolios in corporate equities and other risky securities such as 'junk bonds' and venture funds rather than just in high-grade corporate and government securities.

During the 1970s the US banking sector also experienced significant deregulation. With the inflationary conditions boosting the nominal rates of interest on money-market instruments, through a process that became known as 'disintermediation', money-market funds emerged to offer savers much higher rates of returns than the regulated banks could offer them. Beginning in 1978, the government sought to help the banks compete for depositors by deregulating the interest rates that commercial banks and savings banks could pay to depositors and charge on loans. In this deregulated environment, however, savings and loans institutions (S&Ls), a type of savings bank whose assets were long-lived, low-yield mortgages, found that, unless they could invest in higher-yield assets, they could not compete for household deposits. The regulatory response was the Garn-St. Germain Act of 1982 that permitted the S&Ls to hold junk bonds and to lend to inherently risky new ventures, even while the government continued to guarantee the accounts of S&L depositors.

From `retain and reinvest' to `downsize and distribute'

The stage was now set for institutional investors and S&Ls to become central participants in the hostile takeover movement of the 1980s. An important instrument of the takeover movement was the junk bond – a corporate or government bond that the bond-rating agencies considered to be below 'investment grade'. In the early 1970s, the main sources of junk bonds were 'fallen angels' – previously investment-grade bonds the ratings of which had been downgraded – or 'Chinese paper' – low-grade bonds that had been issued as part of the conglomerate mania of the 1960s – as distinct from newly issued bonds (see Taggart 1988; Bruck 1989: 27, 37–38, 44). The innovation of Michael Milken, an employee at the Wall Street investment bank of Drexel, Burnham, and Lambert, was to create a liquid market in junk bonds by convincing financial institutions to buy and sell them (Bruck 1989: ch. 1). In the early 1970s, when Milken initiated this new financial market, it was mainly the mutual funds, faced by a slumping stock market, which were willing and able to become players. But, over the next decade, financial deregulation brought, first, pension funds and insurance companies and, then, S&Ls into the junk-bond market. From the late 1970s, it became possible to issue new junk bonds, most of which were used at first to finance management buyouts of divisions of corporations, a mode of undoing the errors of the conglomerate movement of the 1960s that left the new independent companies with huge debt burdens. By the early 1980s, and especially after the Garn-St. Germain Act of 1982 enabled S&Ls to enter the market, it became possible to use junk bonds to launch hostile takeovers of even the largest corporations (Gaughan 1996: 302). Milken orchestrated most of these hostile takeovers by gaining commitments from institutional investors and S&Ls to sell their shareholdings in the target company to the corporate raider, when the target company was taken over, to buy newly issued junk bonds that enabled the company to buy the raider's shares.

The result was (until, beginning in late 1986, the arbitrageur Ivan Boesky and then Milken as well as others were indicted and eventually imprisoned for insider trading) the emergence of a powerful market for corporate control – something of which the agency theorists of the 1970s had only dreamed. The ideology of the market for corporate control lent powerful support to the claim that such takeover activity was beneficial to the corporations involved and indeed to the US economy as a whole. Takeovers, it was argued, were needed to 'disgorge the free cash flow' from companies (Jensen 1989). The exchange of corporate shares for high-yield debt forced liquidity on the acquired or merged companies. These takeovers also placed managers in control of these corporations who were predisposed towards shedding labour and selling off physical assets if that was what was needed to meet the corporation's new financial obligations and, indeed, to push up the market value of the company's stock. For those engaged in the market for corporate control, the sole measure of corporate performance became the enhanced market capitalization of the company after the takeover.

If the attempts to engage in corporate governance reform on the principle of creating shareholder value had been confined to the takeover movement of the 1980s, the rise of shareholder value as a principle of corporate governance might have met a rapid demise in the US with the stock-market crash of 1987. Instead the US stock market made a rapid recovery, and since that time has had the longest bull-run in its history. During the 1990s, it would appear US corporations have been extremely adept at 'creating shareholder value'.

Increasingly during the 1980s, and even more so in the 1990s, support for corporate governance on the principle of creating shareholder value came from an even more powerful and enduring source than the takeover market. In the name of 'creating shareholder value', the past two decades have witnessed a marked shift in the strategic orientation of top corporate managers in the allocation of corporate resources and returns away from 'retain and reinvest' and towards 'downsize and distribute'. Under the new regime, top managers downsize the corporations they control, with a particular emphasis on cutting the size of the labour forces they employ, in an attempt to increase the return on equity.

Since 1980, most major US corporations have been engaged in a process of restructuring their labour forces in ways that have eroded the quantity of jobs that offer stable employment and good pay in the US economy.[3] Hundreds of thousands of previously stable and well-paid blue-collar jobs that were lost in the recession of 1980–2 were never subsequently restored. Between 1979 and 1983, the number of people employed in the economy as a whole increased by 377,000 or 0.4 per cent, while employment in durable goods manufacturing – which supplied most of the well-paid and stable blue-collar jobs – declined by 2,023,000, or 15.9 per cent (U.S. Congress 1992: 344).

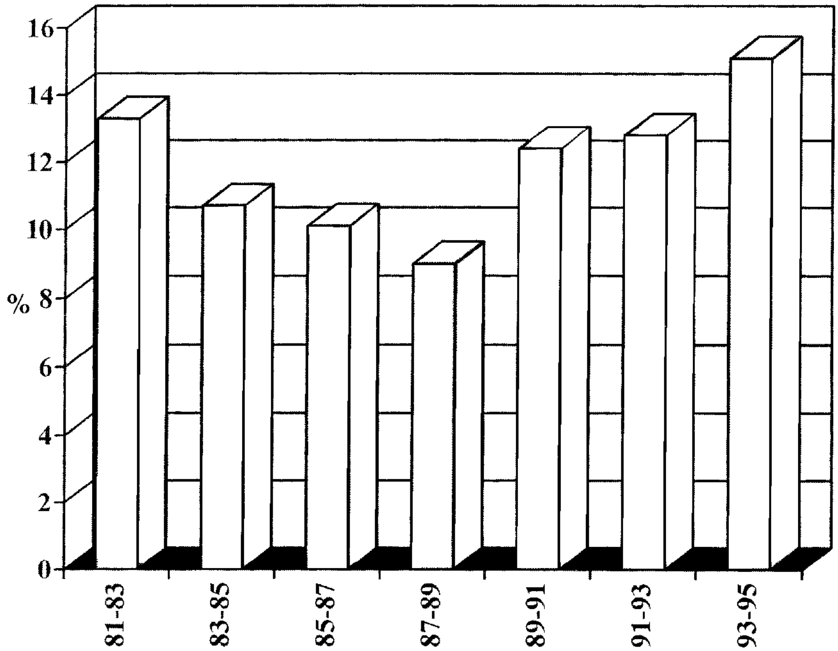
Indeed, the 'boom' years of the mid-1980s saw hundreds of major plant closures. Between 1983 and 1987, 4.6 million workers lost their jobs, of which 40 per cent were from the manufacturing sector (Herz 1990: 23; more generally, see Staudohar and Brown 1987; Patch 1995). The elimination of well-paid and stable blue-collar jobs is reflected in the decline of the proportion of the manufacturing labour force that is unionized from 47.4 per cent in 1970 to 27.8 per cent in 1983 and to 18.2 per cent in 1994 (US Dept of Commerce 1975: 375; 1995: 444; US Bureau of the Census 1976: 137).

Not only were blue-collar workers affected by the mounting predilection of US corporate managers towards downsizing during the 1980s and 1990s. The 'white-collar' recession of the early 1990s saw the elimination of the positions of tens of thousands of professional, administrative and technical employees – salaried white-collar workers who were considered to be members of 'management'. Even in this recession, however, it was blue-collar workers who bore the brunt of displacement.

Overall, the incidence of job loss in the first half of the 1990s stood at about 14 per cent, even higher than the quite substantial rates of about 10 per cent in the 1980s. The rate of job loss for 1981–3, a period with a slack labour market, was about 13 per cent. As the labour market tightened during the mid-1980s, the rate of job loss fell. As the economy went into recession from 1989, the job-loss rate increased again to a level similar to that in the recession of the early 1980s, notwithstanding the fact that the recession of the late 1980s was much milder. Moreover, even as the economy moved into a recovery from 1991, the job-loss rate rose to ever higher levels, a trend that continued through 1995, despite an acceleration of economic growth (see Figure 1).

Leading the downsizing of the 1980s and 1990s were many of America's largest corporations. In the decades after World War II, the foundations of US economic development were the willingness and ability of the nation's major industrial corporations to allocate their considerable financial resources to investment strategies that created the good jobs that many Americans began to take for granted. In 1969, the fifty largest US industrial corporations by sales directly employed 6.4 million people, equivalent to 7.5 per cent of the civilian labour force. In 1991, these companies directly employed 5.2 million people, equivalent to 4.2 per cent of the labour force (Lazonick and O'Sullivan 1997: 3). And since 1991 the downsizing of these companies has gone forward at a steady pace. By the early 1990s even US firms known for their no-lay-off commitments – IBM, DEC, Delta – had undergone significant downsizing and lay-offs of blue- and white-collar workers (Weinstein and Kochan 1995: 16).

The American Management Association (AMA) conducts a survey every year of lay-offs by major US companies.[4] A striking finding of this survey is that job elimination has continued to be pervasive among US corporate enterprises leading to substantial reductions in their workforce(s), notwithstanding the considerable improvement in the business cycle during the 1990s. Moreover,



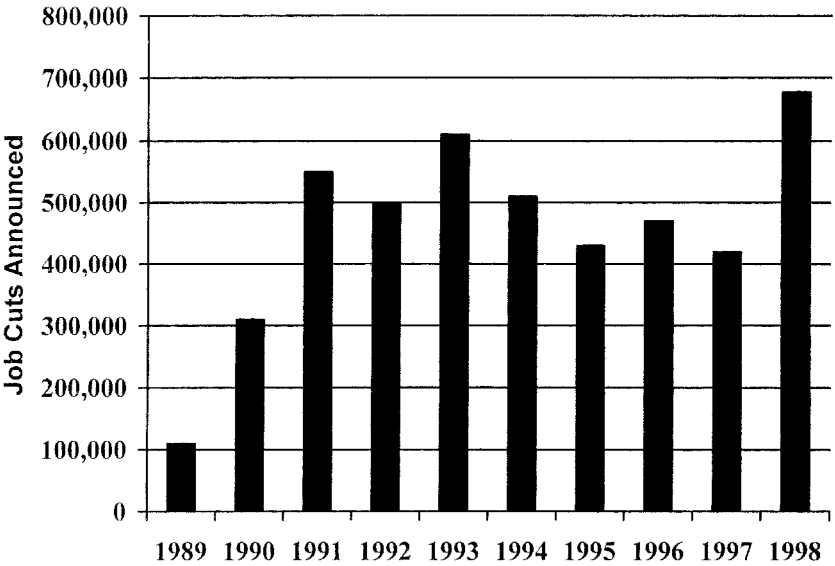
Source: Farber (1997)

Figure 1 Rate of job loss in the US: annual average number of jobs lost as a proportion of the labour force

notwithstanding the downward trend since 1994–5 in the proportion of companies reporting job elimination, the most recent Challenger, Gray and Christmas estimates of announced staff cuts by major US corporations suggests that another upsurge in lay-offs by US corporations is in the offing (see Figure 2). The AMA survey shows, moreover, that job cutting is much more prevalent among larger employers than smaller ones. Almost 60 per cent of companies that employed more than 10,000 people laid off some of their workforce in 1996–7 (American Management Association Surveys various years). In the boom year of 1998 the number of announced staff cuts by major US corporations was greater than for any other year in the 1990s.

The costs of job loss to displaced workers have been substantial. They have a large probability – around 35 per cent on average – of not being employed two years after displacement. On average, displaced workers, when re-employed, receive real weekly earnings that are some 13 per cent less than before they lost their original jobs (about 9 per cent for workers displaced from full-time jobs who are re-employed on full-time jobs) (Farber 1997). And these are estimates only of the wage effects of losing a job.

There are, of course, other costs to workers of downsizing. Prominent among them is growing worker insecurity at the prospect of losing a job, and the anxiety



Source: Challenger, Gray, and Christmas

Figure 2 Announced staff cuts by major US corporations 1989–98

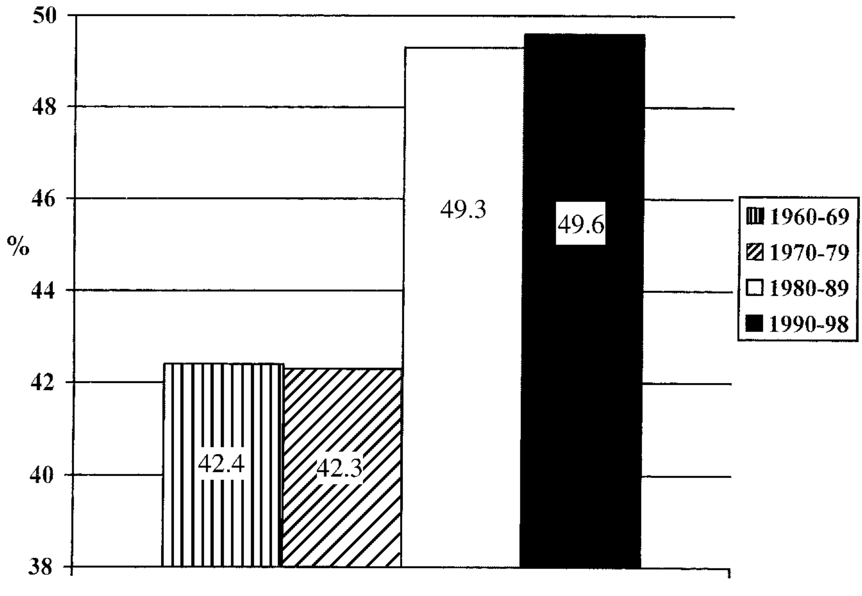
that these expectations breed. A commonly used, although imperfect, proxy for a change in job security is a change in job tenure. From 1983 to 1998 there was a slight decline in the median years of tenure of employed wage and salary workers with their current employer from 5.0 years to 4.7 years. But the average for male and female workers masks significant differences by gender. For male workers aged 25 years and over, median tenure fell from 5.9 years to 4.9 years from 1983 to 1998. A decline in tenure was particularly pronounced for men aged 55 to 64, falling from 15.3 years to 11.2 years between 1983 and 1998. It is especially striking that these overall declines were registered within the context of a general trend towards an ageing of the male workforce. Among men, in all age groups, the fall in tenure was sufficiently great to outweigh the positive impact of ageing on tenure. In contrast, women aged 25 years and over enjoyed an increase in median tenure from 4.2 years to 4.4 years, although some of this effect was a result of the ageing of the female workforce. Most age groups within the female working population experienced the increase in median tenure, with the notable exception of women aged 55 to 64 years, whose median tenure fell from 9.8 years in 1983 to 9.6 years in 1998.

As proxies for job security, job tenure figures must be used with caution. With lay-offs occurring on a large scale, the proportion of workers with long tenure could rise, not because workers as a group are enjoying greater employment security, but because workers with lower seniority are being laid off. In the aircraft and parts industry, for example, a sharp rise in median tenure from 6.3 in

1991 to 9.6 in 1998 at a time of widespread lay-offs seems to be, at least partly, attributable to this effect (US Bureau of Labor Statistics various years).

While US corporate managers became focused on downsizing their labour-forces in the 1980s and 1990s, they also became focused on distributing corporate revenues in ways that supported the price of their companies' stocks. During the 1950s, 1960s and 1970s the pay-out ratio (the ratio of dividends to after-tax adjusted corporate profits) varied from a low of 37.2 per cent in 1966 (when increases in dividends lagged increased profits) to a high of 53 per cent in 1974 (when profits fell by 19 per cent while dividends went up by 8 per cent). But averaged over any five-year period during these three decades, the pay-out ratio stayed remarkably stable, never going above 45.9 per cent (1970–4) and never falling below 38.8 per cent (1975–9). The stability is even greater over ten-year periods – 47.9 per cent for the 1950s, 42.4 per cent for the 1960s and 42.3 per cent for the 1970s (see Figure 3). These pay-out ratios were high by international standards, manifesting the extent to which US corporations returned value to stockholders even before the rise of the institutional investor.

Compared with the 1960s and 1970s, an upward shift in corporate pay-out ratios occurred in the 1980s and 1990s. In 1980, when profits declined by 17 per cent (the largest profits decline since the 1930s), dividends rose by 13 per cent, and the pay-out ratio shot up 15 points to 57 per cent. Thereafter, from 1980 through 1998, the pay-out ratio fell below 44 per cent only twice, in 1984 and



Source: US Congress (1992: 403; 1999: 431)

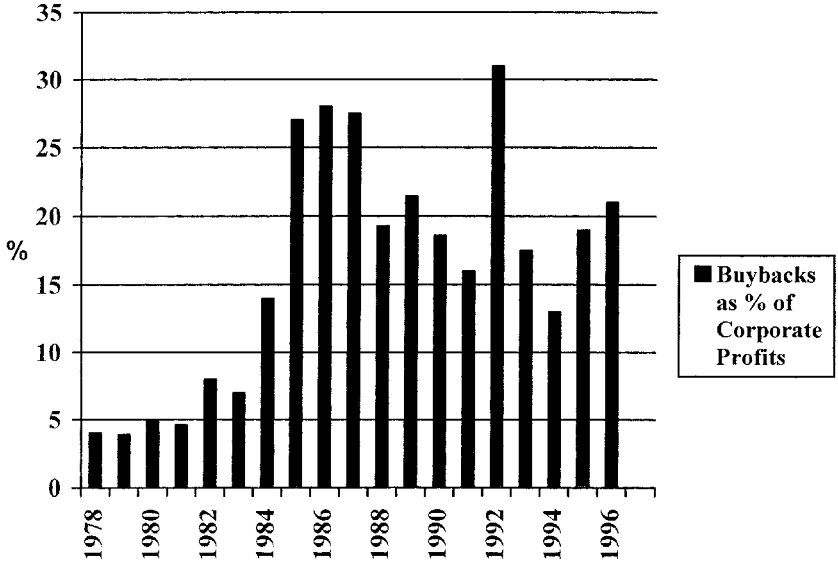
Figure 3 US corporate pay-out ratio (1960–98): corporate dividends as a percentage of corporate profits after tax with inventory valuation and capital consumption adjustments

1985, and even then not because dividends fell but because the increase in dividends did not keep up with the increase in profits. There was no five-year period within the period 1980 to 1998 during which the pay-out ratio did not average at least 44 per cent, and over the nineteen years it averaged over 49 per cent (O'Sullivan 2000: fig. 6.4; US Congress 1999: 431).

Since the mid-1980s, moreover, increases in corporate dividends have not been the only way in which corporations have distributed earnings to stockholders. Prior to the 1980s, during a stock-market boom, companies would often sell shares on the market at inflated prices to pay off debt or to bolster the corporate treasury. In general, although equity issues have never been an important source of funds for investment in the development and utilization of the productive capabilities of US corporate enterprises, they tended to issue more equities than they repurchased. But, during the 1980s, the net equity issues for US corporations became negative in many years, largely as a result of stock repurchases.

In 1985, when total corporate dividends were $84 billion, stock repurchases were $20 billion, boosting the effective pay-out ratio from under 40 per cent, based on dividends only, to 50 per cent with the addition of stock repurchases. In the quarter following the stock market crash of 1987, there were 777 announcements by US corporations of new or increased buybacks ('The buyback monster', *Forbes,* 17 November 1997). In 1989, when dividends had risen to $134.4 billion, stock repurchases had increased to over $60 billion, increasing the effective pay-out ratio to over 81 per cent. With close to $70 billion in stock repurchases in 1994, the effective pay-out ratio was about 66 per cent. In 1996, stock repurchases were $116 billion, for an effective pay-out ratio of 72 per cent ('The hidden meaning of stock buybacks', *Fortune*, September 1997). Although for any one year the announced buyback plans tend to be lower than actual repurchases, the continuing high levels of announced buyback plans since 1996 suggest that US corporate enterprises continue to favour buybacks as a respectable use for their cash; US corporations announced plans to buy back $177 billion of stock in 1996, $181 billion in 1997, and $207 billion in 1998 (see Figure 4).

For many major US corporations stock repurchases have now become a systematic feature of the way in which they allocate revenues and a critically important one in terms of the amount of money involved. General Electric is a good example. From 1994 to 1998, its cumulative dividend growth was 84 per cent compared with 29 per cent for the population of S&P 500 firms. Moreover, during the same period, the cumulative amount of cash that GE spent on share repurchases at $14.6 billion rivalled the $15.6 billion paid out in cumulative dividends. Together these two outflows of cash amounted to an extraordinary 74.4 per cent of GE's cumulative cash from operations from 1994 to 1998. Notwithstanding the enormous amounts that the company has already spent on repurchases, in December 1997, GE's Board of Directors increased the authorization to repurchase company stock to a massive $17 billion (GE 10K 1998). It is perhaps not coincidental that since 1981, when the current CEO, Jack Welch, took office, GE has set the tone for downsizing among corporations.



Source: Securities Data Corporation

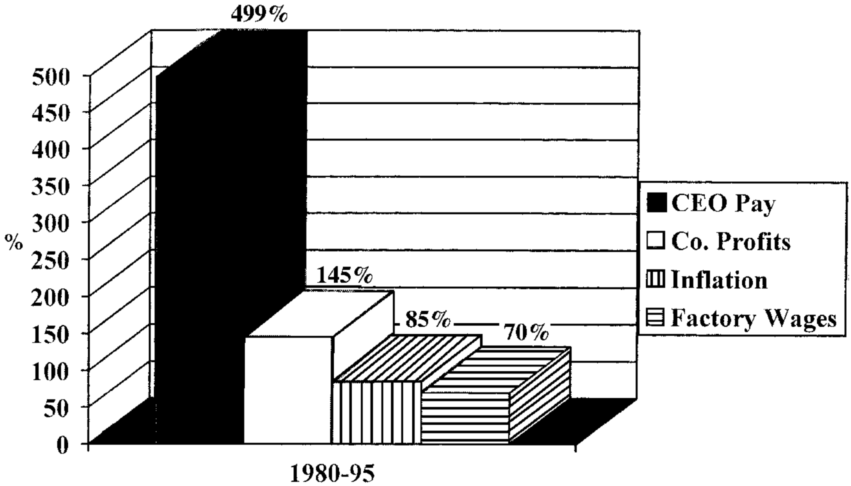
Figure 4 Buybacks as a share of US corporate profits 1978–96

Why and how did this shift in the orientation of top managers from retain and reinvest to downsize and distribute occur? Corporate governance for most US corporations from their emergence in the late nineteenth and early twentieth century through the 1970s was based on the strategy of retain and reinvest. Top managers tended to be integrated with the business organizations that employed them and governed the corporate enterprises that they controlled accordingly. One condition that supported this integration of top managers into the organization was the separation of share ownership and managerial control. In the absence of hereditary owners in top management positions, career employees who worked their way up and around the managerial hierarchy could realistically hope to rise to top management positions over the course of their careers. Into the 1970s the salaried compensation of top managers was largely determined by pay structures within the managerial organization.

Forces were at work from the 1950s that increasingly segmented top managers of US corporations from the rest of the managerial organization. Top managers of many US corporations began receiving stock options in 1950, after tax changes made this form of compensation attractive. During the 1950s and 1960s, with the stock market generally on the rise, gains from the exercise of these options and the holding of stock became increasingly important components of the incomes of top managers. When, in the early 1970s, the stock market turned down, many corporate boards transformed worthless stock options into increases in salaried remuneration, on the grounds that these managers could not be blamed for the general downturn in the stock market. In effect, the *expectations* of gains from stock options that had been formed during the general rise in the stock market in the 1950s and 1960s came to be considered, along with salaries, as part of the basic compensation of top managers. Thus began a trend that during the 1970s favoured the pay of top managers over the pay of everyone else in the corporation (see Figures 5 and 6). During the 1980s and 1990s the explosion in top management pay has continued unabated, with stock-based rewards playing an ever more important role (Hall and Liebman 1997). On average, the pay packages of CEOs of US corporations were forty-four times those of factory workers in 1965, but 419 times in 1998 (*Business Week* 20 April 1998, 19 April 1999).

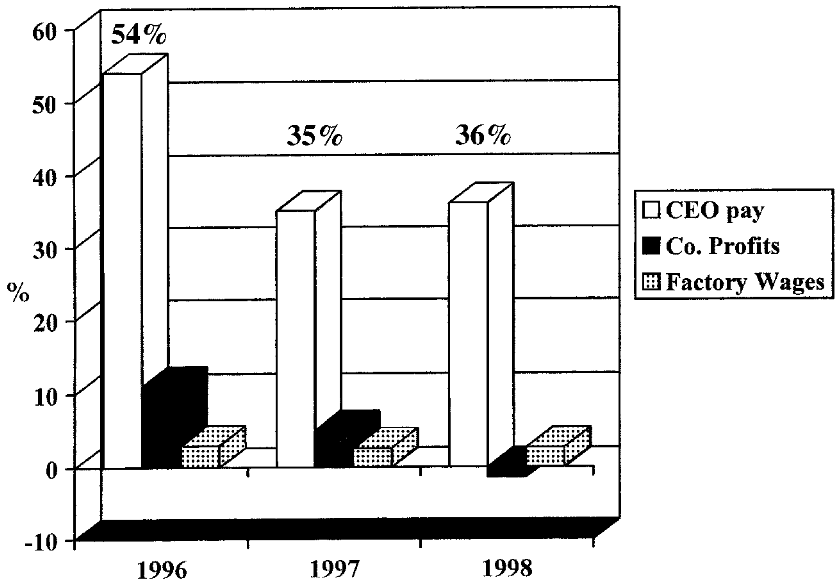
From the 1950s, therefore, US corporate managers developed an ever-growing personal interest in boosting the market value of their companies' stock. Yet even though US companies had relatively high pay-out ratios by international standards in the 1950s, 1960s, and 1970s, during these decades US top managers remained oriented towards a strategy of retain and reinvest rather than simply using corporate revenues to increase dividends or repurchase stock to boost stock prices. The fact is that, given the dominance that these corporations exercised over many of their product markets, the pursuit of retain and reinvest strategies permitted lots of different stakeholders to gain. Workers could get paid higher wages and have better employment stability and working conditions; suppliers and distributors could make more profits, some of which could potentially be passed on to their workers; consumers could get lower prices on the goods that they purchased; the dividends to stockholders could be maintained or even increased; and there could still be substantial funds left over for the corporation to reinvest either within the United States or, as was increasingly the case in these decades, abroad.

Such was the happy situation facing US corporations in their era of unchallenged dominance in the post-World War II decades. It was this environment of



Source: http://www.aflcio.org/paywatch

Figure 5 CEO pay versus factory wages in major US corporations 1980–95



Sources: http://www.aflcio.org/paywatch

Figure 6 CEO pay versus factory wages in major US corporations 1996–8

growth that spawned the belief among many top managers of US corporations that a good manager could manage anything – a belief that the major business schools of the time were happy to propound and that provided a rationale for the conglomeration movement of the 1960s. But in the much more difficult economic environment of the 1970s and early 1980s, this belief in the omnipotence of top management began to be shattered. Indeed, the over-extension of the corporate enterprises into too many different lines of business had helped to foster the strategic segmentation of top managers from their organizations. At the same time, the innovative capabilities of international competitors made it harder to sustain the employment of corporate labour-forces, unless the productive capabilities of many if not most of these employees could be radically transformed. Under these conditions, US corporate managers faced a strategic crossroads: they could find new ways to generate productivity gains on the basis of retain and reinvest or they could capitulate to the new competitive environment through corporate downsizing.

If the changed competitive environment of the 1970s and 1980s made it more difficult for top managers of US corporations to be successful through a strategy of retain and reinvest, increased segmentation within their own organizations made it more difficult for them to understand what type of innovative strategies they should pursue and the capabilities of their organizations to implement these strategies. In addition, by the 1980s the deregulated financial environment and the rise of the institutional investor as a holder of corporate stocks encouraged top managers to align their own interests with external financial interests rather than with the interests of the productive organizations over which they exercised control. Manifesting this alignment was the explosion in top management pay, while the other side of the same paycheck was the shift in the strategic orientation of top management from retain and reinvest to downsize and distribute. With the co-operation of top corporate managers, shareholder value had by the 1990s become a firmly entrenched principle of US corporate governance.

Shareholder value and economic performance

Shareholders and top managers have certainly benefited under the rule of shareholder value (see Table 1). But how has the US economy as a whole performed? Again, as in the case of hostile takeovers and the market for corporate control, financial economists, versed in theories of the inherent economic superiority of market resource allocation over corporate resource allocation, have provided the theoretical rationale for corporate governance in the interests of shareholders with its emphasis on downsize and distribute.[5] Financial economists contend that, when the corporate enterprise maximizes shareholder value, everyone – workers, consumers, suppliers and distributors – will, as a result, be better off. These financial economists posit that shareholders are the 'owners' or 'principals' in whose interests the corporations should be run. They recognize, however, that, in the actual running of the corporation, shareholders must rely on managers to perform certain functions. The proponents of shareholder value have argued, often with justification, that the managers who control the allocation of corporate resources and returns are self-serving in the exercise of this control. As a result, such managers do not adequately 'create value for shareholders'.

When corporations are run to maximize shareholder value, these financial economists argue, the performance of the economy as a whole, not just the interest of shareholders, can be enhanced. In making this claim, advocates of

Table 1 US corporate stock and bond yields 1950–98: per cent, annual averages

	1950–9	*1960–9*	*1970–9*	*1980–9*	*1990–8*
Real stock yield	17.7	8.3	–1.7	11.7	14.3
Stock price yield	14.8	7.5	1.4	12.9	14.8
Dividend yield	4.9	3.2	4.1	4.3	2.6
Change in CPI	2.1	2.4	7.1	5.6	3.1
Real bond yield	1.3	2.7	1.2	5.8	4.9

Sources: US Congress (1992: 366, 378, 397; 1999: 399, 412, 436) maximizing shareholder value rely on arguments that portray any residual revenues – profits – that the corporation generates as rewards for critical economic functions that, allegedly, shareholders perform and without which these residuals would not be possible. In one version of the argument, shareholder returns are regarded as incentives for waiting and risk bearing; in another version, as rewards for shareholder monitoring of managers.

According to the logic of shareholder value theory, if corporate managers cannot allocate resources and returns to maintain the value of the shareholders' assets, then the 'free cash flow' should be distributed to shareholders who can then allocate these resources to their most efficient alternative uses. Since in the modern corporation, with its publicly listed stock, these shareholders have a market relation with the corporation, the economic argument for making distributions to shareholders is an argument concerning the efficiency of the replacement of corporate control over the allocation of resources and returns with market control.

Shareholder value advocates, moreover, point to the stock-market boom throughout the 1990s and the prosperity of the US economy in the late 1990s as proof positive of the economic benefits that the pursuit of shareholder value has delivered. Theory, they argue, has been borne out by practice. Specifically, proponents of 'creating shareholder value' through downsizing and distributing argue:

- US corporations that have engaged in such restructuring have become more efficient, as reflected in enhanced profitability and higher market valuations of their assets.
- The release of labour and capital from major corporations has provided, moreover, the basis for the flourishing of new ventures in industrial districts such as Silicon Valley based on the highly dynamic and internationally competitive US information technologies sector.
- In effect, the dismantling of corporate control over the allocation of resources and returns in the economy has enabled labour and capital markets to reallocate those resources to start-up companies that are fast, flexible and innovative and that are driving the current boom in the US economy.
- In cross-national comparative perspective, such restructuring of existing corporations and the creation of such dynamic new ventures are precisely what are missing in Japan and the advanced nations of Europe.
- Nothing could do more to jumpstart these economies than to import American-style institutional investing and corporate restructuring so that the mechanisms of the market can redirect the allocation of labour and capital to their most profitable uses.

The current boom conditions in the US economy, and the undoubted success of Silicon Valley in the information-technology sector, would seem to provide powerful support to those who argue that the pursuit of shareholder value is the path to sustainable prosperity. Besides the booming stock market, it is common to cite the relatively low rates of unemployment that the United States has achieved in the late 1990s, with an emphasis on the fact that, in February 1999, for the first time since the early 1950s, the official US unemployment rate was lower than the official Japanese unemployment rate.

There are, however, many problems with this rosy view of the power of shareholder value in reshaping corporate governance and, indeed, the organization of the economy to deliver sustainable prosperity. In both theory and practice, the arguments for maximizing shareholder value ignore significant problems of US economic performance in the era of 'downsize and distribute' as well as important historical foundations of the current stock-market and economic booms. A consideration of these problems of economic performance and foundations of the current booms raises serious questions about the future sustainability of US prosperity in a shareholder-value regime.

Problems of US economic performance

Declining employment security, falling job tenures and the significant costs of job loss that many, if not most, Americans have experienced in the 1990s reflect a longer-run trend, dating back to the 1970s, towards a persistent worsening of the distribution of income in the United States. The flexibility of US labour markets may have enabled the US economy to achieve reasonable rates of unemployment in the 1990s, but only at the cost of creating an economy based on low wage rates and incomes for most of the working population. To make ends meet, moreover, most families need incomes from two adults who have to work long hours. Indeed, during the 1990s, the yearly working hours of the average American surpassed those of the average Japanese.

The problem of income inequality in the United States reflects not only significant differences in levels of wages and salaries but also significant inequalities in the distribution of wealth, among which is the distribution of stockholdings. The top half of 1 per cent of all US households in terms of the size of their stockholdings owns, directly or through institutional investors, almost 37 per cent of all outstanding corporate equities, 80 per cent of US households own less than 2 per cent (Poterba and Samwick 1995: 328). The high rates of returns on corporate stocks that have been achieved in the era of shareholder value have served only to exacerbate income inequality in the United States.

During the 1980s and 1990s, while US financial economists have been confidently advocating the creation of shareholder value, US labour economists have been unable to explain the worsening income distribution. In our view, the impacts of the tendency of US corporations to downsize and distribute are only part of the story of the worsening income distribution. Even corporations that *favour* a strategy of downsizing and distributing must, if they are to persist, also engage in strategies that require them to retain and reinvest. Another part of the story of worsening income inequality is what we call the 'skill-base hypothesis': the strategic focus of *innovative* US corporations on those types of activities in which innovation can be generated by investing in 'narrow and concentrated' skill bases of highly educated personnel. In the post-World War II era that extended through the 1970s – decades when US corporate governance favoured strategies of 'retain and reinvest' – US blue-collar or 'hourly' workers were well paid and provided with stable employment, even though by world standards they were poorly educated and trained. During this period there was a general improvement in the distribution of income that contrasts with the worsening of the income distribution since that time. The corporations that employed these workers had achieved market dominance by developing managerial organization and fostering managerial learning, and shared some of the gains of this dominance with production workers, whose co-operation was required on the shop-floor.

But in the 1970s and 1980s, the lack of investment in shop-floor skills proved to be the Achilles heel of US corporations in international competition, and especially in competition with Japanese companies that had innovated by investing in broader and deeper skill bases than US companies. In response to the historical legacy of the US economy in neglecting investment in shop-floor skills in the face of competitive challenge from abroad, the retention and reinvestment strategies of US corporations in the 1980s and 1990s focused on activities in which they could innovate and compete by investing in the capabilities of only the most highly educated personnel. Indeed, in engaging in these activities and investing in these employees, US corporations are able to draw on an international pool of highly educated labour. This labour comes to the United States in search of high-paid employment, often by way of one or more university degrees from world-class universities and departments in the US system of higher education. The skills-base bias of US corporate investment and the availability of a well-educated international labour supply have meant, moreover, that corporate America has had little interest in upgrading the quality of education available to most Americans. This is evidenced by the highly unequal and, by international standards, generally inferior system of mass education in the United States.

Foundations of the current prosperity

It is common in the late 1990s for Americans to tout the innovation and prosperity of Silicon Valley as an outcome of the corporate restructuring of the past two decades that has made both capital and labour free to move into new ventures. This view, however, ignores historical accumulations of resources and capabilities in districts such as Silicon Valley that have made the current prosperity possible. In effect, the prosperity of Silicon Valley in the 1990s owes more to the post-war 'military industrial complex', in which 'retain and reinvest' corporations such as IBM, Hewlett Packard, Motorola and Xerox were central, rather than it does to a resurgence of entrepreneurship – something that has always been in abundant supply in the United States. The success of these corporations in developing and utilizing technologies was in turn highly dependent on massive government procurement contracts and research initiatives. In historical perspective, the current re-allocation of labour and capital to new ventures in the United States is, therefore, just the most visible tip of the military-industrial complex – a developmental iceberg that took the American economy decades to put in place. Given the focus of US corporations on downsizing and distributing, as well as the US government's retreat from investments in basic research, there are questions about whether the American economy is currently generating the new technological infrastructure that can provide foundations for sustainable prosperity in the twenty-first century.

If there are questions about the foundations and future of productive investment in the United States, there are also questions about the sources and availability of American savings. Corporate policies of 'downsize and distribute' have provided the underlying impetus to the stock-market boom of the 1990s, but the sustained and rapid rate of increase in stock prices is the result of a massive flow of funds into the stock market through equity-based mutual funds. Since the 1960s US households have been increasing the proportion of their financial assets that are invested in pension and mutual funds. From 1982 to 1994 pension and mutual funds alone accounted for about 67 per cent of the net growth of the total financial assets of households (Edwards 1996: 16–27).

Reflecting their growing importance in managing the savings of US households, pension and mutual funds' shares of corporate equities have increased dramatically. Pension funds held 24 per cent of US corporate stock in 1997, with private pensions accounting for 13.8 per cent and public pensions for 10.2 per cent, compared with 0.3 per cent in 1945. Over the same period, mutual funds increased their share of US corporate stock from 1.5 per cent to 16.2 per cent. A substantial proportion of the recent upsurge in the share of mutual funds is attributable to their growing popularity for pension provision; at the end of 1996, retirement-plan assets represented 35 per cent of all mutual fund assets. In contrast to the growing importance of institutional investors, the share of corporate stocks held directly by individuals has fallen from 93 per cent in 1945 to 42.7 per cent in 1997 (US Board of Governors various years). Institutional share ownership is even higher in the largest US corporations than in the population of corporate enterprises as a whole. In 1987, the institutional share of the equity of the top 1,000 US corporations was 46.6 per cent; by 1995 it had increased to 57.2 per cent (Brancato 1997).

The shift of stockholdings to institutional investors had by no means exhausted itself by the mid-1990s. During the last half of the 1980s, the net new cash flow into equity mutual funds ranged from a high of about \$21.9 billion in 1986 to a low of minus \$16.2 billion in 1988. During the early 1990s, however, the flow of new money into mutual funds picked up speed, and during 1993–5 net additions to mutual funds averaged about \$125 billion per year. In 1996 and 1997 the net additions to equity mutual funds rose to the unprecedented levels of \$217 billion and \$227 billion respectively. In the first seven months of 1998, the pace of inflows remained vigorous. However, in conjunction with the downturn in the US stock market in August 1998, the inflow of cash slowed down sufficiently to bring the net inflow for the year to $159 billion, which represented a 30 per cent fall compared with 1997. Yet, as the market regained its vigour in late 1998 and especially in early 1999, inflows revived again (Investment Company Institute).

The origins of this 'new' money are not well documented. What is clear, however, is that the savings rate of US households, already low by international standards in the 1980s, has plunged further in the 1990s. An older generation of Americans – the ones who were able to accumulate significant savings, pensions and other assets during the era of 'retain and reinvest' – appear to be reallocating their financial resources to capture the returns of the booming stock market. But what if, as appears to be the case, the younger generations, living in an era of 'downsize and distribute', will not have the same opportunities as the older generations for the accumulation of financial assets? And, indeed, what if the returns to the financial assets of older generations, who have become increasingly reliant on the stock market for returns on their savings to fund their consumption expenditures, cannot be sustained?

Is the current prosperity sustainable?

We must consider the possibility that the US stock-market boom is encouraging US households to live off the past while corporations have less incentive to invest for the future. The current consumption-driven boom seems to be closely tied to the stock-market boom. For the first time in US history, the returns to the savings of American households are directly dependent on the sustainability of high yields on corporate stock. What will happen to US consumption, and to the US (and world) economy, if the US stock market should turn down, and stay down?

Yet the stock-market boom has not made capital available to industry. The persistent and massive flow of funds into stock-based mutual funds in the 1990s has bid up stock prices, increasing the market capitalizations of corporations. But, as we have seen, net corporate equity issues have been negative over the course of the 1990s because of corporate stock repurchases, while the main impact of the stock-market boom on capital markets has been to raise consumption.

No one knows the 'real' limits to the current stock-market boom. What we can say is that, unlike the speculative stock-market booms that occurred in the late 1920s in the United States, and in the late 1980s in Japan, in which corporations sold stock at high price–earnings ratios to increase their cash reserves or pay off debt, the current US boom is being supported by corporate cash distributions. What is the continuing capacity of US corporations to support stock prices through 'downsize and distribute' strategies?

A proponent of shareholder value would argue that vibrant new ventures are replacing the stodgy old corporations that are being downsized. But even if one were to accept the claim that the stock-market boom has induced entrepreneurs to set up new ventures with their eyes on the prospect of not-too-distant and very lucrative initial public offerings, are new ventures sustainable if they are governed by the principle of shareholder value? One important effect of the stock-market boom on new ventures has been to make them dependent on the performance of the stock market even before these enterprises themselves have gone public. Most new ventures finance themselves by the willingness of employees to accept shares in the company in lieu of immediate remuneration. But should the stock market turn down, and with it the expectations for gains on the sale of shares in a successful IPO, many new ventures will find that the financial commitment required to secure the personnel to develop and utilize the enterprise's productive resources are beyond their financial means or those of the venture capitalists who support them.

Indeed, it is not just new ventures that are looking to stock-market gains to pay employee compensation. In 1998, for example, the widespread use of stock options to attract and reward employees meant that Intel spent more than twice as much on stock repurchases than on R&D (Intel 10K 1999). During the same year, Microsoft's stock repurchases were almost equal to its in-house spending on R&D (Microsoft 10K 1999). We have no precedent for examining how, given such remuneration schemes, strategically central corporations such as these would be affected by a stock-market collapse. However, it is worthwhile remembering that Intel and Microsoft were once new ventures that transformed themselves into going concerns by establishing themselves as key suppliers to IBM. IBM was a US corporation that epitomized governance according to the principles of 'retain and reinvest', while Intel and Microsoft became dominant in their sectors by governing themselves according to the same principles. The experience of the United States suggests that the pursuit of shareholder value may be an appropriate strategy for running down a company – and an economy. The pursuit of some other kind of value is needed to build up a company and an economy.

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Notes

1 An important analysis of US loss of competitive advantage in a number of major industries can be found in Dertouzos *et al.* (1989).

2 The following paragraphs on the transformation of the US financial sector are based on Lazonick and O'Sullivan (1997); see also Lazonick (1992) and O'Sullivan (2000: ch. 5).

3 The following paragraphs on downsizing of labour and distribution of earnings are drawn from O'Sullivan (2000: ch. 5).

4 The AMA survey is sent to human resources managers in AMA member companies every year. AMA's corporate membership consists of 9,500 organizations which together employ 25 per cent of the American workforce. Over 85 per cent of surveyed firms gross more than $10 million annually, which puts them among the top 5 per cent of US corporations.
5 For an elaboration of shareholder theory and a critique, see O'Sullivan (1999).

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