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The Economic Case for Corporate Responsibility to Workers

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With the Dow Jones industrial average above 5500 and corporate profits at a 25-year high, corporate America may have fulfilled Wall Street's highest expectations. But higher profits and productivity have failed to deliver higher wages and job security, and business finds itself accused of putting corporate greed ahead of the nation's economic interests.

Observers across the political spectrum have found the behavior of numerous companies unseemly. Many large, successful corporations are permanently downsizing their workforces while earning record profits. Corporate executives are raking in multi-million-dollar pay packages while workers' pay stagnates or declines. Republicans such as Massachusetts Gov. William Weld and presidential contender Robert Dole have lectured corporations on their responsibilities to their workers and communities. Democrats such as Senators Edward Kennedy and Jeff Bingaman, Congressmen Richard Gephardt and David Bonior, and Labor Secretary Robert Reich have gone further and suggested that the government provide incentives that reward good corporate behavior and punish bad.

Wall Street and the business community have responded by defending their obligation to maximize shareholder value. As former Scott Paper chief executive officer Albert S. Dunlop put it, "The reason to be in business is to make money for your shareholders. The shareholders own the company. They take all the risks." Among these shareholders, the argument goes, are pension funds and mutual funds serving a broad swath of American workers and consumers. The bottom line of this argument is that everyone is better off when corporate managers maximize shareholder value.

This argument, however, is based on widely held economic myths. There is, however, a strong economic case to be made for a broad vision of corporate responsibility that includes workers as well as shareholders.

Problems With the 'Shareholder' Argument

Shareholders do not "own" companies. Rather, they have an equity stake. Corporations do not exist in Adam Smith's description of a free-market economy because they are not a product of free markets—they were created by state intervention. The laws that set up corporations separate the ownership of equity claims (shares of stock) from the ownership of property. Owners of a few shares of stock in a company are not entitled to the ordinary rights of property ownership-the rights to possess, use, dispose of, exclude others, manage, and control the company. In addition, shareholders are exempt from the liabilities usually associated with ownership. If the company pollutes the Love Canal, installs asbestos in nursery schools, or makes silicon breast implants, the shareholders cannot be personally sued, no matter how wealthy they may be. If the company goes bankrupt and leaves creditors holding the bag, the creditors cannot recover what they are owed from the shareholders' personal assets; liability is limited to the value of their shares.

In other words, shareholders who invest in a company are owners of stock in the company, not the company itself. As we show below, their stake is similar to that of employees, who invest their time and skills in the expectation that the company and they, in turn, will benefit.

Employees, like shareholders, bear the risks of investing in the corporation. Shareholders who have invested in the stock of a company get their piece of the corporate pie only if there is something left after all expenses are paid. Thus, they bear the risk that nothing will be left for them. They have an interest, therefore, in monitoring management to ensure that corporations are managed efficiently and that these residual gains (profits) are maximized. Economic theory says that companies are likely to be run more efficiently when corporate managers are accountable to those who bear such risks.

But employees make investments and bear risks as well. In most employment relationships, employees invest in skills and knowledge that are specific to the company. Their payoff comes in the form of wages that are higher than what they can earn in a job at another firm-but only if the company prospers and employs them in the future. Because they bear risks in the same way as shareholders, employees are equally motivated to see that the firm's resources are used efficiently and that the firm prospers.

Downsizing is not necessarily an effective way to maximize shareholder value. Certainly some companies have seen employment shrink as they became more efficient. But productivity growth is a gradual process. As the regional Bell company Nynex demonstrated, it is possible to plan for this type of reduction in staff in a way that minimizes the devastating effects on individuals and communities. No company can credibly claim that productivity growth requires sudden drastic or across-the-board cuts in employees.

Wall Street equates efficiency with layoffs, but almost half the productivity gains in the U.S. economy come from companies that "upsized" and added employees. Surveys by the American Management Association show that most companies that downsize do not meet their goals for increasing productivity or profit. According to the AMA, many try to make good by downsizing again. A study comparing the financial performance of downsized firms over a period extending from three years before the downsizing to two years after found that the firms as a group performed no better two years after downsizing than they did before. Still, the pressure to downsize tends to crowd out more effective strategies for improving firm performance.

Downsizing is often a cover for mismanagement. AT&T Chief Executive Officer Robert Allen committed what a *Wall Street Journal* columnist called "a $7.5 billion boo boo" when he bought NCR Corp. in 1990. AT&T is also writing off hundreds of millions of dollars it invested in online services it is now phasing out. Other stumbles include its $150 million investment in Unitel, a Canadian long-distance network that went bankrupt. The result of ail these mistakes? On January 2, CEO Allen announced that AT&T is eliminating 40,000 jobs.

"Maximizing shareholder value" benefits only a small segment of the population. Federal Reserve data show that more than 5 1 million Americans owned some stock in 1992, either directly or indirectly through mutual funds and defined-contribution pension and savings plans. However, an analysis of these data by economists James M. Poterba and Andrew A. Samwick shows that most of these holdings are minuscule. They found that the wealthiest 10% of households own 90% of stocks; the wealthiest 20% own 98%. The remaining 80% of middle-class and working-class households own only 2% of stocks, either directly or indirectly. When holdings in pension and retirement savings accounts are subtracted, the share of stocks owned by this 80% of households drops to a mere 0.5%. Thus, middle-class households benefit little, if at all, from a rise in the Dow Jones average.

One group that clearly benefits from a rise in the stock price is the corporate managers themselves. The most tangible accomplishment of the shareholders' revolt has been to change the compensation package so that top managers' pay depends far more heavily than before on the stock-market performance of the company. This focuses the attention of top corporate managers on movements in share prices, sometimes to the exclusion of other goals. At AT&T, Mr. Allen's pay consists of $5.85 million in salary and bonus and nearly $11 million in stock options, enough presumably to encourage him to focus on AT&T's share price. And AT&T is not alone: CEO pay at some large corporations more than doubled last year. According to a survey by compensation consulting company Pearl Meyer & Partners, average CEO pay at large companies rose to $4.37 million in 1995, a 23% increase overall and a 45% increase in stock-option grants.

Tilting the compensation package so heavily toward stock options provides corporate officials with a personal motive for ignoring the claims of other stakeholders and with enticements to enrich themselves on short-term jumps in share prices. An overemphasis on short-term increases in share price can undermine the long-term viability of the company to the detriment of employees, creditors, and long-term stockholders.

A Broader View of Corporate Responsibility

Like shareholders, employees make investments in a firm and take risks. Unlike most shareholders, however, employees' livelihoods can be severely threatened by poor investment decisions and bad management. Shareholders, after all, rarely have more than 2% or 3% of their holdings in any one company. And it is far easier for investors to sell their shares when they see that a company is poorly managed than it is for workers to change jobs. In most cases, employees with years of experience are unable to find other jobs at their previous wages. Decisions in which they had no part have essentially wiped out their investments in skills and knowledge. This is not only unfair, it is an inefficient use of society's resources.

As stakeholders in the corporation whose incomes depend on the company's profitability and ability to employ them, employees should have the same rights and opportunities as shareholders to hold managers accountable. Moreover, their knowledge of the company and its customers may make them better suited than more distant shareholders to monitor management's decisions and assure that they serve company interests.

The first corporations were established by government expressly to pursue public purposes, and states today charter corporations under their authority to promote the common welfare. Government already sets the rules by which corporations must be governed. Workers' rights to representation, like those of shareholders, should be legally mandated in the rules of corporate governance. Specifically:

- Employees should have a voice in decisions that affect the viability of the company. We propose that a significant proportion-perhaps a third-of a corporation's board of directors be elected by employees.
- Because employees invest in firm-specific skills, they should participate in decisions about training. Training committees composed of employees and managers should decide both the content of company training and who gets it. Employee participation within a high-performance work system can bring new ideas to bear on how to increase everyone's returns on investment.

As Senator Bill Bradley has said, "The form has yet to emerge, but the need to involve employees in dealing with the future-even a frightening future—should be obvious." These are two steps that can be taken to ensure that corporate executives pursue high returns for all stakeholders in their companies.

Suggested reading

Baker, Dean. 1996. "Trends in Corporate Responsibility: Getting More for Less?" Technical Paper, Economic Policy Institute, Washington, D.C.

Appelbaum, Eileen, and Peter Berg. 1995. "Financial Market Constraints and Business Strategy in the United States." Technical Paper, Economic Policy Institute, Washington, D.C.