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Comments on the Draft of the 2014-2015 Revision of the OECD Principles of Corporate Governance

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When the OECD first issued its Principles of Corporate Governance (PCG) in 1999, I was highly critical of its position that business corporations should be run first and foremost in the interests of shareholders, even as it recognized the existence of other stakeholders for whom the firm had certain responsibilities.[2] I based my objections on three decades as an academic economist studying the comparative history of capitalism, with a focus on the investment strategies and organizational structures of business corporations. Until the 1980s, the dominant corporate-governance perspective in the United States as elsewhere was that publicly listed corporations should be run in the interests of a variety of stakeholders, among whom shareholders were not necessarily primary. After the 1980s, the pervasive corporate-governance ideology was that, for the sake of superior economic performance, companies should be run to “maximize shareholder value” (MSV). This new corporate-governance perspective contradicted everything I had learned from the study of history about the roles of the stock market and public shareholders in the development of the advanced capitalist economies, especially the United States where by the 1990s MSV ideology had become most dominant.

In 1999, as the OECD PCG was lending credibility to MSV, Mary O’Sullivan and I launched a three-year research project, Corporate Governance, Innovation, and Economic Performance, based at INSEAD in France and funded by the European Commission.[3] We argued that, like neoclassical economists in general, the agency theorists who propounded MSV lacked a theory of the firm that could explain how business enterprises generate competitive products. From this perspective, the corporate-governance challenge is not to

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[1] These comments elaborate upon remarks that I made at the expert consultation of the OECD Corporate Governance Committee at the OECD in Paris on March 17, 2014.

[2] William Lazonick and Mary O’Sullivan, “Maximizing Shareholder Value: A New Ideology for Corporate Governance,” *Economy and Society*, 29, 1, 2000: 13-35. See also William Lazonick, “Controlling the Market for Corporate Control: The Historical Significance of Managerial Capitalism,’ *Industrial and Corporate Change*, 1, 3, 1992: 445-488; William Lazonick, “Creating and Extracting Value: Corporate Investment Behavior and American Economic Performance,” in Michael Bernstein and David Adler, eds., *Understanding American Economic Decline*, Cambridge University Press, 1994: 79-113; Mary O’Sullivan, “The Innovative Enterprise and Corporate Governance,” *Cambridge Journal of Economics*, 24, 2, 2000: 393-416; Mary O’Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany*, Oxford University Press, 2000; William Lazonick and Mary O’Sullivan, eds. *Corporate Governance and Sustainable Prosperity*, Palgrave Macmillan, 2002.

[3] William Lazonick and Mary O’Sullivan, *Corporate Governance, Innovation, and Economic Performance in the EU: Final Report*, Targeted Socio-Economic Research (TSER) Report to the European Commission (DGXII) under the Fourth Framework Programme, European Commission (Contract no.: SOE1-CT98-1114; Project no: 053), May 2002 (published by EU Socio-Economic Research of the European Commission, December 2004), at ftp://ftp.cordis.europa.eu/pub/citizens/docs/soe1-ct98-1114_21037cgep.pdf.

maintain transparent and efficient markets, as PCG has it, but rather to allocate corporate resources to generate high-quality, low-cost products in ways that result in stable and equitable economic growth. An understanding of the types of economic actors who make investments in this process exposes two fundamental flaws in MSV, neither of which is recognized in the current revision of PCG.

The first flaw is the assumption that of all participants in the business enterprise only shareholders make investments in the firm's productive assets without a guaranteed return. The second flaw is the assumption that all shareholders, by virtue of owning corporate shares, actually make investments in the firm's productive assets. Let me outline why each of these assumptions is wrong as a prelude to my claim that PCG requires much more drastic revision if it is to provide guidance to government policy-makers and business executives about how a corporate governance framework can promote, rather than undermine, the attainment of stable and equitable economic growth.

Flaw #1: Shareholders are not the only investors in the firm

The MSV argument is that, of all participants in the business corporation, shareholders are the only economic actors who make investments in productive assets without a guaranteed return.[4] All other participants such as creditors, workers, suppliers, and distributors allegedly receive a market-determined price for the goods or services that they render to the corporation, and hence take no risk of whether the company makes or loses money. On this assumption, only shareholders have an economically justifiable claim to the "residual" that is left over after the company has paid all other participants their guaranteed contractual claims for their productive contributions to the firm.

By the MSV argument, shareholders are the only stakeholders who need to be incentivized to bear the risk of investing in productive resources that may result in superior economic performance. As the only residual claimants, moreover, shareholders are the only stakeholders who have an interest in monitoring managers to ensure that they allocate resources efficiently. Furthermore, by buying and selling corporate shares on the stock market, public shareholders, it is argued, can directly reallocate resources to more efficient uses.

One fundamental problem with MSV lies in the assumption that shareholders are the only corporate participants who bear risk. They are not. On a regular basis, taxpayers through the government agencies that they fund and workers through the firms that employ them make risky investments in the productive capabilities of business enterprises. From this perspective, both the state and labor have "residual claimant" status; that is, an economic claim on the distribution of profits.

[4] For a recent statement of these arguments, see William Lazonick, "Innovative Enterprise and Shareholder Value," *Law and Financial Markets Review*, 8, 1, 2014: 52-64.

Through government investments and subsidies, taxpayers regularly provide productive resources to companies without a guaranteed return. As an important example, but only one of many, the annual budget of the U.S. National Institutes of Health (NIH) is about $30 billion, with a total NIH investment from 1938 through 2013 of $875 billion in 2013 dollars.[5] As risk bearers in making such investments, taxpayers have a claim on corporate profits if and when they are generated. Through the tax system, governments, representing taxpayers in general, can seek to extract this return from individuals and corporations that reap the returns of government spending. Through the political process, however, tax rates and revenues are subject to change, and hence the returns to taxpayers for these investments in productive capabilities are by no means guaranteed.

Workers regularly make productive contributions to the companies for which they work through the exercise of skill and effort beyond those levels required to lay claim to their current pay, but without guaranteed returns.[6] In essence, these types of employees are making investments in the firm. Any employer who is seeking to generate a higher quality, lower cost product knows the profound productivity difference between employees who just punch the clock to get their daily pay and those who engage in learning to make productive contributions through which they can build their careers and thereby reap future returns in work and in retirement. Indeed, employers often say that the company's most valuable assets are its human assets. As for economists, the notion of "investment in human capital" has been a central concept for more than half a century.

Yet the careers of the employees who make these investments in the firm's productive assets and the returns that their ongoing employment can generate in the forms of pay and promotion are not guaranteed. When, in the name of "shareholder value," a profitable company lays off long-serving employees on the grounds that it no longer needs their services, financial interests, including top executives who implement the downsizing, are often depriving these employees of the current value that their years of prior service helped to create.

As risk bearers, therefore, taxpayers whose money supports business enterprises and workers whose efforts generate productivity improvements have claims on corporate profits if and when they are forthcoming. MSV ignores the risk-reward relation for these two types of economic actors in the operation and performance of business corporations.[7]

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[5] National Institutes of Health, NIH Budget, at http://www.nih.gov/about/budget.htm; see also William Lazonick and Öner Tulum, "US Biopharmaceutical Finance and the Sustainability of the Biotech Business Model," *Research Policy*, 40, 9, 2011: 1170-1187. On U.S. government investment in high-technology industry more generally, see Matt Hopkins and William Lazonick, "Who Invests in the High-Tech Knowledge Base?" Institute for New Economic Thinking Working Group on the Political Economy of Distribution Working Paper No. 6, October 2014.

[6] William Lazonick, *Competitive Advantage on the Shop Floor,* Harvard University Press, 1990; William Lazonick, Philip Moss, Hal Salzman, and Öner Tulum, "Skill Development and Sustainable Prosperity: Collective and Cumulative Careers versus Skill-Biased Technical Change," Institute for New Economic Thinking Working Group on the Political Economy of Distribution Working Paper No. 7, December 2014.

[7] William Lazonick and Mariana Mazzucato, "The Risk-Reward Nexus in the Innovation-Inequality Relationship: Who Takes the Risks? Who Gets the Rewards?" *Industrial and Corporate Change*, 22, 4, 2013: 1093-1128.

Instead it erroneously assumes that only shareholders are "residual claimants." For the sake of both equity and efficiency, a theory of corporate governance must contemplate that, alongside certain types of shareholders, taxpayers and workers may be *investors* in the firm. Indeed rather than continue to use the highly ambiguous term "stakeholders," I would recommend (as elaborated below) that PCG adopt the term "investors," with the recognition that certain types of government spending and certain types of human effort may represent investments in the firm on a par with financial investments by certain types of shareholders.

Flaw #2: Not all shareholders are investors in the firm

The irony of MSV theory – and the second major flaw in its argument – is that the public shareholders whom it holds up as the only risk bearers do not typically invest in the productive capabilities of the corporation at all. Rather they invest in outstanding shares in the hope that they will rise in price on the market. From the perspective of the business enterprise, these shareholders are traders in its outstanding shares, not investors in its productive assets.

Conventional wisdom is that the role of the stock market is to channel the savings of tens of millions of households into an exchange process that enables businesses that issue stock to raise capital for investment in productive capacity. Yet the historical evidence shows that only in periods of speculative fervor such as the late 1920s, the late 1950s, and the late 1990s has the stock market provided significant amounts of funding to companies.[8] Historically, corporate retentions are by far the most important sources of new funds for reinvestment in a company.[9] In general the primary role of the stock market has been to permit owner-entrepreneurs and their private-equity associates to exit personally from investments that have already been made rather than to enable a corporation to raise funds for new investment in productive assets.[10]

As applied to the rise of the large U.S. industrial corporation in the late 19th and early 20th centuries, it is generally assumed that the increasing capital requirements of companies in high fixed-cost industries such as steel, oil refining, chemicals, electric power, farm equipment, and automobiles outstripped the financial capacity of family proprietors and partnerships, thus necessitating raising capital on the stock market.[11] In their book *The Modern Corporation and Private Property*, published in 1932,[12] Adolf Berle and Gardiner Means accepted this "capital constraint" explanation for the separation of stock

[8] Mary O'Sullivan, "The Expansion of the U.S. Stock Market, 1885-1930: Historical Facts and Theoretical Fashions," *Enterprise & Society*, 8, 3, 2007: 489-542; Mary O'Sullivan, "Funding New Industries: A Historical Perspective on the Financing Role of the U.S. Stock Market in the Twentieth Century," in Naomi R. Lamoreaux and Kenneth L. Sokoloff, eds., *Financing Innovation in the United States, 1870 to the Present*, MIT Press, 2007: 163-216.

[9] Jenny Corbett and Tim Jenkinson, "The Financing of Industry, 1970-1989: An International Comparison," *Journal of the Japanese and International Economies*, 10, 1, 1996: 71-96.

[10] William Lazonick and Mary O'Sullivan, "Finance and Industrial Development, Part I: The United States and the United Kingdom," *Financial History Review*, 4, 1, 1997: 7-29.

[11] For a summary of these views, see O'Sullivan, "Expansion of the U.S. Stock Market."

[12] Adolf A. Berle and Gardner C. Means, *The Modern Corporation and Private Property*, Macmillan, 1932.

ownership from managerial control, and continued to do so in their later writings. For example, in his 1954 book, *The 20th Century Capitalist Revolution*, Berle states that the separation of stock ownership from managerial control "was inevitable, granting that modern organizations of production and distribution must be so large as to be incapable of being owned by any individual or small group of individuals."[13]

The historical facts do not support this argument. The primary reason for the separation of ownership and control in building the large-scale business enterprise was *not* to overcome the capital constraint but rather to overcome the managerial constraint. The work of Alfred Chandler and other historians of "the managerial revolution in American business" – to quote the subtitle of Chandler's 1977 book, *The Visible Hand* – show that the critical constraint on the growth of major industrial enterprises was not access to finance capital but rather the management of organizational capabilities that could develop and utilize productive resources, and thus manage the growth of the firm.[14] The centrality of managerial organization in the growth of the large-scale industrial enterprise was captured abstractly, but cogently, in Edith Penrose's landmark book, *The Theory of the Growth of the Firm*, first published in 1959.[15]

From the perspective of sustained industrial innovation, therefore, the key impact of the separation of ownership from control in the United States was to overcome the managerial constraint on the building of organizational capabilities and the growth of the firm. Moreover, the way in which ownership was separated from control enhanced the access of these firms to committed finance, rooted in retained earnings and supplemented by bond issues, to fund investments in organization and technology. The managerial revolution in American business was a powerful engine of economic growth, especially in corporations that invested in deep technological capabilities. And the main role of the stock market was to enable the separation of managerial control from stock ownership.

If the stock market has been relatively unimportant in funding the emergence and growth of U.S. industrial corporations, since the mid-1980s, coincident with the rise of MSV ideology, U.S. industrial corporations have become major funders of the stock market. Figure 1 shows net equity issues of U.S. corporations from 1946 to 2013. Net equity issues are new corporate stock issues minus outstanding stock retired through stock repurchases and M&A activity. Over the decade 2004-2013 net equity issues of non-financial corporations averaged *minus $376 billion per year*.[16] For the first nine months of 2014, the net equity issues deficit was an annually adjusted $427 billion.

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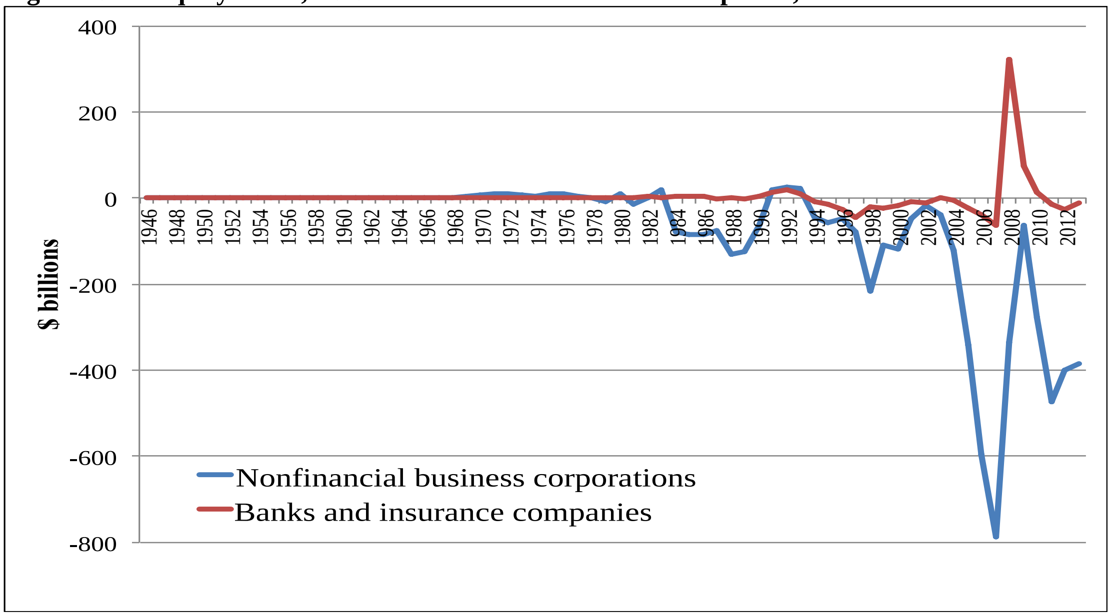
13 Adolf A. Berle, Jr., *The 20th Century Capitalist Revolution*, Harcourt, Brace and Company, 1954, p. 30. See also Gardiner C. Means, "Hessen's 'Reappraisal'," *Journal of Law and Economics,* 26, 2, 1983, p. 2298.

14 See William Lazonick, "Alfred Chandler's Managerial Revolution" in William Lazonick and David J. Teece, eds., *Management Innovation: Essays in the Spirit of Alfred D. Chandler, Jr.*, Oxford University Press, 2012.

15 Edith T. Penrose, *The Theory of the Growth of the Firm*, Blackwell, 1959. See William Lazonick, "The US Industrial Corporation and *The Theory of the Growth of the Firm*," in Christos Pitelis, ed., *The Growth of the Firm: The Legacy of Edith Penrose*, Oxford University Press, 2002: 249-277.

16 Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release Z.1, "Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts," Table F-213, "Corporate Equities", December 11, 2014. The spike in equity issues for financial corporations in 2009 occurred when they sold

Figure 1. Net equity issues, U.S. nonfinancial and financial companies, 1946-2013



Source: Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release Z.1, "Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts," Table F-213: Corporate Equities, March 6, 2014.

In terms of gross funding of the stock market by industrial corporations, over the decade 2004-2013, about 9,000 U.S. companies expended a total of $6.9 trillion on stock buybacks.[17] That was 43 percent of their combined net income, with dividends absorbing another 47 percent. Companies in the S&P 500 Index did about half of the buyback total.[18] The 454 companies included in the S&P 500 Index in March 2014 that were publicly listed from 2004 through 2013 expended $3.4 trillion on buybacks, equal to 51 percent of net income, and another $2.3 trillion on dividends, 35 percent of net income.[19] And buybacks remain in vogue: For the 12-month period ending September 2014, S&P 500 companies spent $567 billion on buybacks, up 27 percent from the previous 12-month period.[20]

These massive distributions to shareholders are often described as "unlocking shareholder value" and "returning value to shareholders."[21] But how can one "return" value to those who never invested in the process of creating that value? Large sums of the

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stock to the U.S. government in the bailout. The banks that were bailed out had been major repurchasers of their stock in the years before the financial meltdown. See William Lazonick, "Everyone is paying the price for share buy-backs" *Financial Times*, September 26, 2008, p. 25; William Lazonick, "The buyback boondoggle," *BusinessWeek*, August 24 & 31, 2009, p. 96.

[17] Standard & Poor's Compustat database; 9,000 companies is an annual average.

[18] Research by Mustafa Erdem Sakinç of the University of Bordeaux for The Academic-Industry Research Network (www.theAIRnet.org).

[19] William Lazonick, "Cash Distributions to Shareholders (2004-2013) & Corporate Executive Pay (2006-2012)," Research Note, The Academic-Industry Research Network, at http://www.theairnet.org/v3/home/1009-2/; research by Mustafa Erdem Sakinç for The Academic-Industry Research Network.

[20] Factset, "Buyback Quarterly, December 16,2014, at http://www.factset.com/websitefiles/PDFs/buyback/buyback_12.16.14

[21] See, for example, William Lazonick, Mariana Mazzucato, and Öner Tulum, "Apple's Changing Business Model: What Should the World's Richest Company Do With All Those Profits?" *Accounting Forum*, 37, 4, 2013: 249-267.

disgorged cash flow have been placed in the hands of powerful investment bankers and hedge-fund managers who tend to use their control over vast wealth to extract even more cash out of the productive economy through distributions to shareholders.[22] In principle, these powerful actors in the financial economy could mobilize financial resources for investment in value-creating capabilities in the productive economy. Indeed, historically, a major business of Wall Street was the undertaking of bond issues that leveraged a company's retained earnings. Increasingly, however, Wall Street has found ways to make far more money as value-extracting "activists" than as value-creating investors.

Stock buybacks are at the core of MSV, serving as the most important, and most damaging, mode of "disgorging" the corporation's "free" cash flow.[23] MSV theory contends that the economy is burdened with agency costs whenever shareholders as principals have to delegate decision-making power to managers as their agents, and, hence, for superior economic performance the incentives of corporate executives must be aligned with the interests of shareholders.[24] Table 1 shows the extent to which the alignment of the incentives of the senior executives with MSV has been achieved.

Table 1. Mean total direct compensation of the 500 highest-paid executives named in proxy statements, and components of total direct compensation, 2006-2013

			Percentage shares of components of total direct compensation						
	Mean Total Direct Comp. $m.	**Mean Total Direct Comp. 2013 $m.**	**Salary**	**Bonus**	**Non-Equity Incentive Plan**	**All Other Comp**	**Deferred Earnings**	**Realized Stock Option Gains**	**Realized Stock Award Gains**
2006	**27.4**	**30.8**	3.3	7.0	7.6	5.9	0.5	58.9	16.8
2007	**30.0**	**32.9**	3.0	4.1	6.9	7.6	0.1	58.8	19.6
2008	**22.9**	**24.6**	4.1	4.2	8.7	4.1	0.1	43.9	34.9
2009	**14.4**	**15.4**	7.0	4.8	14.9	7.4	0.1	39.9	25.9
2010	**18.5**	**19.5**	5.5	4.8	15.0	6.2	0.1	40.3	28.1
2011	**19.4**	**20.0**	5.5	4.8	15.0	6.2	0.1	40.3	28.1
2012	**30.3**	**30.8**	3.6	2.7	8.2	3.2	0.1	41.5	40.7
2013	**32.2**	**32.2**	3.3	1.9	7.6	3.5	0.1	55.4	28.2

Source: Standard and Poor's ExecuComp database, with calculations by Matt Hopkins, The Academic-Industry Research Network

In 2012 and 2013, the remuneration of the highest-paid executives was about three times in real terms its level in the early 1990s when it was already seen as excessive.[25] By far the largest components of top executive pay were stock-based in the forms of gains from

[22] See, for example, William Lazonick, "What Apple should do with its massive piles of money," *Harvard Business Review Blog Network*, October 20, 2014, at http://blogs.hbr.org/2014/10/what-apple-should-do-with-its-massive-piles-of-money/; Joe Nocera, "Carl Icahn's bad advice," *New York Times*, October 24, 2014, at http://www.nytimes.com/2014/10/25/opinion/joe-nocera-carl-icahns-bad-advice.html?_r=0

[23] The evocative notion of disgorging the so-called free cash flow from business corporations comes from Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers" *American Economic Review* 76, 2, 1986: 323-329.

[24] Michael C. Jensen and Kevin J. Murphy, "Performance Pay and Top Management Incentives," *Journal of Political Economy*, 98, 2, 1990: 225-264.

[25] Graef S. Crystal, *In Search of Excess: The Overcompensation of the American Executive*, Norton, 1991; William Lazonick, "Taking Stock: How Executive Pay Results in an Inequitable and Unstable Economy," Franklin and Eleanor Roosevelt Institute White Paper, June 5, 2014, at http://www.rooseveltinstitute.org/taking-stock-executive-pay.

exercising stock options and gains from the vesting of stock awards. Since 2006, for the 500 highest paid executives in the ExecuComp database, stock awards and stock options combined ranged from 66 percent to 84 percent of total remuneration.

The incentives of the executives of major U.S. corporations have become aligned with the interests of shareholders who extract value that they had no part in creating. What has happened to the trillions upon trillions of dollars that have been disgorged from U.S. industrial enterprises via buybacks over the past three decades? Has a significant amount of it been reinvested in productive capabilities? We have every reason to think that it has not.

My research supports the hypothesis that the "buyback corporation" has contributed to an economy in which, since the late 1970s, income has become increasingly concentrated among the top 0.1 percent of households, while middle-class employment opportunities for the U.S. labor force have disappeared.[26] Over that period the resource-allocation regime at many, if not most, major U.S. business corporations has transitioned from "retain-and-reinvest" to "downsize-and-distribute." Under retain-and-reinvest, the corporation retains earnings and reinvests them in the productive capabilities embodied in its labor force. Under downsize-and-distribute, the corporation lays off experienced, and often more expensive, workers, and distributes corporate cash to shareholders.[27] My research suggests that, with its downsize-and-distribute resource-allocation regime, the buyback corporation is in large part responsible for a national economy characterized by income inequity, employment instability, and diminished innovative capability – or the opposite of what I have called "sustainable prosperity."[28]

Implications for the revision of OECD PCG

The OECD PCG views the function of a "corporate governance framework" as "the promotion of transparent and efficient markets," with the addition of "fair" markets in the current draft (p. 3).[29] From my perspective, a corporate governance framework is concerned with the allocation of corporate resources to generate high-quality, low-cost (i.e., competitive) products.[30] Contrary to the ahistorical (neoclassical) theory of the market economy on which the PCG definition of corporate governance appears to be based, well-developed markets in finance, labor, and products are the *results*, not the causes, of successful business enterprise, generally supported by government investments

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[26] William Lazonick, "Labor in the Twenty-First Century: The Top 0.1 Percent and the Disappearing Middle Class," AIR Working Paper #14-08/01, August 2014, forthcoming in Christian Weller, ed., *Financial Market Development and Labor Relations*, Labor and Employment Research Association, 2015. See also William Lazonick, "Profits Without Prosperity: Stock Buybacks Manipulate the Market and Leave Most Americans Worse Off," *Harvard Business Review*, September 2014: 46-55.

[27] Lazonick and O'Sullivan, "Maximizing Shareholder Value".

[28] William Lazonick, *Sustainable Prosperity in the New Economy? Business Organization and High-Tech Employment in the United States*, Upjohn Institute for Employment Research, 2009.

[29] All parenthetical page references are to the OECD Principles of Corporate Governance, Draft for Public Comment – November 2014.

[30] Lazonick and O'Sullivan, *Corporate Governance, Innovation, and Economic Performance in the EU.*

in physical infrastructure and human knowledge.[31] Given the collective and cumulative character of the learning processes required to generate innovative (higher quality, lower-cost) products, it is the investment strategies and organizational structures of business enterprises that drive the development of the economy.

Given the intellectual dominance of the neoclassical theory of the market economy in OECD countries, it is not surprising that OECD has applied this perspective to issues of corporate governance. But the theory of the market economy does not explain the growth of the firm, with very large corporations dominating the economy across a range of key sectors. It is the growth of the firm that makes corporate governance a central policy issue precisely because massive amounts of productive resources on which our wellbeing depends are allocated by organizations, not markets.

One can have different views of the roles of stock buybacks, stock-based pay, investment bankers, and hedge-fund activists in the operation and performance of the economy. But, even if OECD could somehow avoid confronting these phenomena in 1999 and 2004, there is no justification for PCG to be silent on these issues in 2014-2015. With its misplaced focus on the promotion of transparent and efficient markets, PCG continues to avoid raising, let alone addressing, the key corporate governance issues of our times.

At the same time, even as it reinforces what many have called "shareholder primacy," PCG recognizes the interests of other "stakeholders," and particularly employees, in matters of corporate governance. If, as I have suggested above, PCG replaces the term "stakeholders" by "investors" while recognizing that taxpayers and workers may be investors and that not all "shareholders" are investors, the OECD principles can begin to address the issues of how the business corporation can allocate resources to generate competitive products and contribute to stable and equitable economic growth.

There is already language in the current revision of PCG that permits OECD to make the argument that business corporations should be run for the communities of investors representing the state, labor, and finance. But these statements are placed at the end of PCG, where they appear to represent an afterthought, using the catchall and hence ill-defined "stakeholder" terminology. These statements include:

- "The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to take due regard of, and deal fairly with, other stakeholder interests including those of employees, creditors, customers, suppliers and local communities. Observance of environmental and social standards is relevant in this context." (p. 30)

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[31] Lazonick, Business Organization and the Myth of the Market Economy, Cambridge University Press, 1991; William Lazonick, "The Theory of the Market Economy and the Social Foundations of Innovative Enterprise," *Economic and Industrial Democracy*, 24, 1, 2003: 9-44. For my latest iteration of the theory of the firm that builds on this perspective, see William Lazonick, "The Theory of Innovative Enterprise: A Foundation of Economic Analysis," AIR Working Paper #13-05-01, May 2013 at http://www.theairnet.org/files/research/WorkingPapers/Lazonick_InnovativeEnterprise_AIR-WP13.0501.pdf

- "In some countries, the board is legally required to act in the interest of the company, taking into account the interests of shareholders, employees, and the public good. Acting in the best interest of the company should not permit management to become entrenched." (p. 30)
- "The board should apply high ethical standards. It should take into account the interests of stakeholders." (p. 31)

If one takes these statements seriously, they render meaningless all the previous discussion of the company being run in the interests of its shareholders. The problem is that in practice, where MSV theory goes unchallenged, these statements are not taken seriously. OECD needs a theory of the productive firm (or what I call "the innovative enterprise") both to justify treating taxpayers and workers as investors and to debunk the notion that those who own shares in a company are necessarily investors in that company.

On page 8 of PCG, OECD, parenthetically, recognizes that executives and boards must exercise business judgment in corporate decision-making. Indeed, it can be argued that even in the United States it is the "business judgment rule," not MSV, that is the key principle that should govern resource-allocation decisions.[32] Later in PCG, there is the statement: "*The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.*" (p. 23) Investment strategies and organizational structures are "material matters regarding the corporation," but it is only people who have an intimate understanding of the strategies and structures of the corporation who can make informed judgments about the potential for generating competitive products in an inherently uncertain environment. It is for this reason that in the public corporation there is a separation of share ownership from managerial control, and it is for this reason that the abilities and incentives of executives and directors are of critical importance to the competitive success of the business enterprise.

PCG goes on to state: "A strong disclosure regime that promotes real transparency is a pivotal feature of market-based monitoring of companies and is central to shareholders' ability to exercise their ownership rights on an informed basis." (p. 23) But the uncertainty and complexity of business decisions renders "market-based monitoring" inadequate and often irrelevant, while the ease with which shareholders can buy and sell shares on the stock market means that their incentives and abilities as stock-market traders are fundamentally different from the incentives and abilities of investors whose returns to investment depend on the success of the firm in generating competitive products. It is for this reason that boards of directors need to be composed of representatives of investors in productive assets – taxpayers, workers, and financiers – who will derive returns on those

[32] See Lynn Stout, *The Shareholder Value Myth: How Putting Shareholder Value First Harms Investors, Corporations, and the Public*, Berrett-Koehler Publishers, 2012, pp. 29-31.

investments from the transformation of the productive assets in which they have invested into competitive products.

In the section of PCG entitled "issues regarding employees and other stakeholders" (pp. 26ff), OECD states that "[c]ompanies should provide information on key issues relevant to employees and other stakeholders that may materially affect the performance of the company. Disclosure may include management/employee relations, including remuneration, collective bargaining coverage, and mechanisms for employee representation, and relations with other stakeholders such as creditors, suppliers, and local communities." (p. 26) PCG goes on to say that "[s]ome countries require extensive disclosure of information on human resources. Human resource policies, such as programmes for human resource development and training, retention rates of employees and employee share ownership plans, can communicate important information on the competitive strengths of companies to market participants."

From my perspective on corporate governance, the disclosure of this type of information may be useful to those "market participants" who want to trade in corporate shares. But this type of information is far more important for government policy-makers and labor organizations who want to ensure that valuable human capital is not wasted or permitted to atrophy when a business corporation decides that it no longer requires the services of experienced workers who have the abilities and incentives to remain productive in society. Especially in a "downsize-and-distribute" corporate governance environment, there is a need for workforce investment programs and "flexicurity" institutions to ensure that, for the sake of households and society, valuable human capital finds productive employment that preserves, makes use of, and further develops the productive capabilities of the labor force.

Substantial government revenues are required to fund such "full-employment" initiatives. Profitable business corporations that have benefited from investments in productive capabilities by the state and labor should be paying their fair share of taxes to support these workforce employment and development programs. In this regard, I was struck by the statement that qualifies PCG's discussion of how board members "should act...in the best interest of the company and shareholders." (p. 30) The statement reads: "In nearly all jurisdictions, the duty of care does not extend to errors of business judgement so long as board members are not grossly negligent and a decision is made with due diligence etc., or to an obligation to pursue aggressive tax avoidance." (p. 30) Is OECD PCG condoning "tax avoidance", and if so what is meant by "aggressive"? A Principle of Corporate Governance should be that, in recognition of the manifold productive goods and services that taxpayer money provides to business corporations, there is an obligation for corporations to treat the taxpayer fairly. Corporations should follow the tax rules, but business leaders as a group should advocate for tax rules that are fair, given the companies' use of public investments in physical and human capital. Taxpayers should have representatives on corporate boards if only to ensure that value is returned to taxpayers for the investments in productive capabilities that this group of economic actors has made.

More generally Principles of Corporate Governance promulgated by OECD should promote "retain-and-reinvest" as a corporate resource-allocation regime, while discouraging "downsize-and-distribute." Labor representatives should be on corporate boards. Beyond that, PCG could call for a legislative ban on stock buybacks the purpose of which is to manipulate a company's stock price. PCG should also recommend that executive pay be tied to the productive success of the organization as a whole rather than the company's stock price or earnings per share, both of which can be manipulated. PCG states: "Insider trading and market manipulation should be prohibited and the applicable rules enforced." (p. 18) The applicable rules should be a ban on manipulative buybacks and restraints on stock-based executive pay.

In evaluating the success of the business corporation, PCG needs to contemplate that attainment of higher earnings by employees may represent a return on their investment rather than just a business expense. So too in the case of tax payments to governments. Toward the beginning of the revised document, PCG states: "The functioning of stock markets plays a pivotal role for the quality of corporate governance. This is where stocks and voting rights change hands and where the economic value of governance efforts is manifested." (p. 5) This statement is pure shareholder-value ideology. Higher labor earnings to workers and higher government tax revenues may manifest "the economic value of governance efforts."

In sum, PCG requires a dramatic change in the accepted purpose of the corporation and the composition of corporate boards. The purpose of the business corporation is to produce high quality, low cost, i.e., competitive, goods and services. If the business corporation can perform this role, then profits will follow. The board of directors should be composed of people who have insights into how a company can generate competitive products, including representatives of workers and taxpayers who collectively invest in the production process, These board members should be capable of exercising sound judgment of the types of investment in productive capabilities that the company should make, the returns to investors that are warranted, as well as the company's responsibilities to the society of which it is a part.

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About theAIRnet

The Academic-Industry Research Network – theAIRnet – is a private, 501(c)(3) not-for-profit research organization devoted to the proposition that a sound understanding of the dynamics of industrial development requires collaboration between academic scholars and industry experts. We engage in up-to-date, in-depth, and incisive research and commentary on issues related to industrial innovation and economic development. Our goal is to understand the ways in which, through innovation, businesses and governments can contribute to equitable and stable economic growth – or what we call "sustainable prosperity".

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