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RESEARCH

The Economics of Corporate Governance

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KEY TAKEAWAYS

- We examine whether corporations should benefit shareholders or stakeholders and the purpose and impact of corporate governance provisions.
- The global financial crisis and climate change concerns have increased criticism of the doctrine of shareholder value maximization (SVM).
- The literature suggests SVM and investor-centric governance tools, rooted in the agency view of the firm from the 1970s, remain relevant.

Dimensional's recent paper "The Economics of Corporate Governance" provides a concise overview of the corporate governance literature. We focus on the governance of for-profit, publicly traded corporations and address two important questions. First, for whom should such corporations be run, shareholders or stakeholders? Second, what is the impact of governance provisions on shareholder value?

We ground our analysis in the agency view of the corporation, which emphasizes the costs and benefits of delegated power. Under the agency view, a key concern is that directors and executives might use their discretion to advance their own interests at the expense of the constituencies they serve. Corporate governance is thus faced with a fundamental tension between the need to grant directors and executives sufficient discretion to fulfill their duties and the need to establish guardrails to deter possible opportunistic behavior. This tension is central to the two questions we address.

SHAREHOLDER VALUE MAXIMIZATION VS. STAKEHOLDER CAPITALISM

Shareholder value maximization (SVM) assumes that shareholders own the corporation and that it should be run for their sole benefit. This doctrine has been the dominant organizing framework for corporate governance since the 1980s (e.g., Berger, 2017). However, criticism of SVM increased in the wake of the global financial crisis of 2008. More recently, mounting concerns regarding the externalities of corporations, such as greenhouse gas emissions, have fueled skepticism of SVM.

The Business Roundtable Statement (BRT statement) and the Davos Manifesto have reignited interest in the main alternative to SVM, stakeholder capitalism, which asserts that directors and executives should treat stakeholder interests as ends in themselves rather than subordinate them to shareholder interests. Stakeholders are typically defined broadly: For instance, the BRT statement's definition encompasses local communities, suppliers, customers, and employees. Unless the interests of shareholders and other stakeholders are perfectly aligned, prioritizing stakeholder interests amounts, relative to SVM, to a redistribution of wealth from shareholders to other constituencies. This distinction between SVM and stakeholder capitalism was articulated most clearly by Berle (1932) and Dodd (1932).

Before addressing consequences for investors, we draw on the literature to evaluate whether stakeholder capitalism is likely to help stakeholders. The central problem with the current incarnation of stakeholder capitalism is that, rather than granting new contractual protections to stakeholders, it advocates granting additional discretion to directors and executives with the hope that they will use their newfound power to benefit stakeholders.

Recent academic studies do not find evidence that this is happening. Bebchuk and Tallarita (2020) find that BRT signatories consistently opposed shareholder resolutions aimed at granting new protections to stakeholders. For instance, some signatories have opposed proposals to include nonmanagement employees on the board of directors. Other signatories have opposed resolutions to convert from a for-profit corporation to a public-benefit corporation, a hybrid corporate form in which directors must consider the interests of all those materially affected by the corporation's conduct (Murray, 2014; Littenberg et al. 2019). Bebchuk et al. (2022) find that, in private acquisitions of public firms, CEOs fail to use their discretion to negotiate protections for stakeholders. Furthermore, Raghunandan and Rajgopal (2021) find that BRT signatories, relative to industry peers, are more likely to commit environmental and labor-related compliance violations and to have higher carbon emissions.

There is an additional, deeper issue which directly affects investors. Under stakeholder capitalism, corporate officers are free to prioritize the interests of one stakeholder group over another as they see fit. As Tirole (2001) noted, this ambiguity allows corporate leaders to justify essentially any action by invoking the interests of some stakeholder group. Flugum and Souther (2022) find evidence for this phenomenon: CEOs are more likely to invoke stakeholder-friendly rhetoric when their firms experience negative financial results. Stakeholderist rhetoric threatens to weaken the accountability of corporate leaders, a development with the potential to harm both shareholders and other stakeholders.

Bebchuk and Tallarita (2020) contend that external interventions, such as legislation and regulation, are more likely to protect stakeholders than voluntary commitments. For example, in the case of climate change, enacting a carbon tax and letting firms maximize shareholder value subject to this new tax may be more effective than admonishing corporate leaders to voluntarily cut their firms' emissions. Interestingly, some proponents of stakeholder capitalism explicitly position the doctrine as a way to deflect external interventions. Under this view, regulation by democratically elected governments is replaced by CEO discretion, a shift which may undermine regulations that would actually help stakeholders.

What if shareholders themselves want to help other stakeholders? A well-known position, popularized by Milton Friedman, is that the corporation should still maximize shareholder value since individual shareholders can choose, on an individual basis, to redistribute their share of the wealth to other stakeholders. Hart and Zingales (2017) challenge this position. They emphasize that when corporate externalities are hard to reverse (e.g., greenhouse gas emissions), giving collectively through the corporation may be more efficient than giving individually outside the corporation. Importantly, their position, shareholder welfarism, does not reject the premise that the corporation is run for the benefit of shareholders, making it a middle ground of sorts between SVM and stakeholder capitalism.

While it may be attractive in principle, shareholder welfarism faces difficulties. Fama (2020) offers a multipronged critique. Notably, ESG is inherently multidimensional, and shareholders are unlikely to agree about the tradeoffs among competing ESG issues. Prospective shareholders may be hesitant to invest ex ante if they risk ex post expropriation when they are on the losing side of a vote, which may increase a firm's cost of capital. Also, if investors value good ESG characteristics, market prices may already reflect those preferences, giving corporations an incentive to address ESG preferences even under SVM.

CORPORATE GOVERNANCE AND SHAREHOLDER VALUE

There are good reasons for corporations to be run in the interests of shareholders. This leads to a natural follow-up question: What types of governance practices are most beneficial to shareholders? Instead of summarizing the complete body of evidence we survey in our paper, we focus on the recent literature about two key provisions we believe to be central: board composition and antitakeover devices.

On both topics, there is a large amount of consensus in the investment community, and this consensus drives stewardship decisions on trillions of dollars in assets. By and large, proxy voting advisors, asset managers, and institutional investors oppose staggered boards and poison pills, and support the appointment of unconflicted, qualified board members. Despite the intuitive appeal of these practices, proving that they have a positive, causal effect on shareholder value is not trivial. No two corporations are alike (heterogeneity), and good corporations may be more likely to have good governance (reverse causality). Our assessment from various lines of evidence is that the conventional wisdom is largely correct: Weak boards and antitakeover devices do cause lower firm value. This view is buttressed by studies from the last decade that address methodological issues plaguing older research.

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First, on the question of board independence, recent studies rely on sudden directors' deaths (Nguyen and Nielsen, 2010), natural experiments (Sarbanes-Oxley, board reform legislation internationally), and directors' distractions (Masulis and Zhang, 2019) to identify the effect of board independence on firm value. These mechanisms are less likely to be driven by reverse causality; for instance, it is hard to believe that decreases in firm value cause independent directors to suddenly die. The straightforward explanation, that independent directors add value and that their death deprives the corporation of their contribution, is much more plausible. Overall, the literature finds a positive effect of director independence on firm value, consistent with the agency view. Directors who are independent from the executives they must monitor seem more likely to play their role as guardrails against opportunistic behavior, which benefits shareholders.

Second, the academic literature supports the notion that directors' expertise matters for firm value. For instance, one study (Huang et al., 2014) finds that directors with investment banking experience appointed three years before the firm undertakes an acquisition result in more favorable terms for the acquirer. The three-year lag attenuates concerns about reverse causality. Other studies report similar findings for expertise about international trade, corporate social responsibility, and experience with past acquisitions. Directors with specific expertise may be better positioned not only to deter possible opportunistic behavior but also to prevent well-intentioned but misguided initiatives.

The impact of antitakeover devices such as staggered boards and dual-class shares on shareholder value is also the subject of a rich, if not always unanimous, literature. The traditional argument, consistent with the agency view, is that dispersed shareholders face a free-rider problem that takeover markets remediate. While small shareholders have weak incentives to monitor and discipline corporate agents, because they bear the full cost of doing so while receiving a fraction of the benefit, outside acquirers stand to receive a substantial benefit from improving the firm's governance if they acquire a stake that is sufficiently large. Consistent with this intuition, most studies in the 2000s (e.g., Gompers et al., 2003; Bebchuk et al., 2009) found that antitakeover provisions negatively affect firm value. However, more recent studies, such as Johnson et al. (2015) and Cremers et al. (2017), find a positive effect. Amihud et al. (2018) highlight methodological issues with both strands of the literature and conclude that the evidence is weak in either direction.

One recent development helps reconcile these conflicting findings. Studies examining the effect of antitakeover devices (Johnson et al., 2022) and dual-class shares (Cremers et al., 2022) on firms of different ages find a positive effect for young firms and a negative effect for mature firms, a difference that could get obscured in studies that do not control for firm age. These findings, combined with earlier evidence, reinforce the notion that antitakeover devices harm shareholder value for mature firms. Moreover, since antitakeover provisions such as staggered boards or dual-class shares tend to be "sticky"; enacting them without sunsetting clauses is likely to harm shareholder value in the long run. This point is emphasized by Bebchuk and Kastiel (2017) in the case of dual-class shares. Cuñat et al. (2020) complement this picture by providing causal evidence from shareholder proposals that antitakeover devices reduce firm value.

PARTING THOUGHTS

While SVM cannot fully address negative externalities and stakeholder interests, there is scant evidence that alternative doctrines, such as stakeholder capitalism, do so either. There is a risk that stakeholder capitalism may even make things worse by reducing the oversight and accountability of management. More insidiously, there is a risk of substituting CEO discretion for regulations that would actually protect stakeholders.

There is also mounting evidence that governance practices that increase the oversight and accountability of management, like appointing strong boards and letting takeover markets operate freely, benefit firm value. Both results are joined at the hip. The doctrine of shareholder value maximization and the tools of investor-centric governance are both rooted in the agency view of the firm that emerged in the 1970s. Despite challenges, the literature suggests that the agency view, with its emphasis on incentives and the proper balance of power between corporate agents, remains relevant today as a framework to think about the means and purposes of corporate governance.

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