Rethinking The Structure of Corporations

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Transcript

I think capitalism is working very, very well for what it's designed to do from a narrow perspective. I think capitalism, if we let it continue as business as usual, will destroy us. Capitalism does what it's supposed to do very, very well if you look at things from a narrow perspective, but it's a system that's gone awry in the current context. So what I'm hoping to do is deconstruct capitalism a little bit, talk about some other approaches to modifying it or developing another system.

So the question is: What is the source of the problem within capitalism? And I think it really gets down to – and this is by design – it gets down to the leveraging of self-interest to maximize social good. But the way it's done inside major corporations is that the shareholder, or the owner, whoever this is, tries to maximize their returns, and they control the organization, and they try to externalize the costs. So capture all the value and externalize the costs, and that's a great way to maximize, and firms are very good at maximizing revenue capture for their owners.

But from a societal perspective, it sub-optimizes because as an organization you're not trying to maximize value creation overall, you're trying to maximize value capture for one of the stakeholders. And what that means is a lot of costs are pushed out onto society, as well as certain value simply not being created. And this I think is one of the biggest challenges we face, and a root challenge in society, whether it's in terms of environmental degradation, whether it's in terms of economic inequality, whether it's in terms of firms in the economic sphere using whatever leverage they can to influence the political system such that they can profit even further. So this, I believe, is one of the core challenges that we're facing in society.

So then, the question becomes, what solutions do we have? What solutions do we have to the problem of externalization and sub-optimization? And I think we have three. There are three standard solutions, and all of them have their problems.

The first, is there is no problem, "leave it to the market." If you trust the market long enough, it will self-correct, it's a beautiful, invisible hand. Just trust it. To me it sounds like religion. If it's going to kick in quickly, it better happen tomorrow because we're in trouble. (Laughter) And the logic behind it is things like: "Will customers care about the company?" They do, and they say that they do, but the evidence shows that they really don't pay for it. That's not a big factor in their decisions.

So, in my world, I have to do a little *mea culpa* here, in my world, I am a business school professor, and in business schools, the free market is a little bit of the standard dogma. Just trust in it. Trust in the system, and it will work. If you do the right thing, if you do the good thing, you'll get the win-win, right? That's our mantra. Win-win. Win-win. Win-win. Your employees and your customers will love you, and you'll make a ton of money; everybody wins. And obviously, we need to seek that out. It's absolutely critical. And there's a ton of opportunities and we'll have other speakers today that will be speaking to that. But it's not enough, I'm afraid. It's not enough. So one is the free market, that's one possible solution, but I think it's not proving itself to work.

The second says we can't trust the markets, let's regulate. And there's standard battles, and we hear this rhetoric over and over, how much should you regulate, and the Democrats in the States say one thing, and the Republicans another, and it's a blah-blah blah-blah blah we've been hearing forever. And regulation's critically important, but it's not a great instrument. It's very blunt, companies will try to work around it, the people who write the regulation don't have all the information, so it's not the best tool in the world. And even regulators can be co-opted by the economic players.

So the first solution is, "leave it to the market," the second is, "let's regulate."

The third goes even further and says, "Capitalism sucks, have to get rid of it. Let's socialize this and socialize that industry." But again, we know the weaknesses of that solution. We lose the incentive. We lose decision-making happening where there's the best information close to the market.

So that's where we are today. We've got capitalism which creates all sorts of externalities and sub-optimizes, we have three solutions: leave it to the market, regulate, socialize, and all of them have their weaknesses.

What I'd like to propose is a fourth solution, it's not 'instead of,' but hopefully 'in addition to,' and that would be, instead of trying to – as regulation is trying to internalize the costs – what we want to do is internalize the interests. What we want to do is change the objective function, the goal of the firm.

And how do you do that? Well, I'm kind of a realist in some ways. I don't think it's through writing nice mission statements on web pages. I think it has to do with power, and ownership, and control. And I think what we need to do is broaden the ownership of firms so that the interests of various stakeholders are brought within the decision-making process of the firm.

Right now what we have are firms that are trying to maximize shareholder value, and they're having battles with external stakeholders whether it's NGOs, or Unions, or governments, or what have you. Local communities. The battle's taking place across the organizational boundary, and it tends to be late, and reactive, and confrontational.

What if, instead of that, we brought those interests in, into the ownership structure, and let the battle take place within the board, right? My guess is that you'd have better, more effective, quicker decision-making. And you would have externalization of these costs because those costs will now be considered as part of the objective function of the firm, as part of the purpose of the firm. Does it make sense?

I think this solution has a lot of advantages over other solutions. So for example, we're not getting rid of market competition as we would in socialism, so you still have all that value creation and energy that comes out of self-interest. That's hugely important I think. You have finer decision-making taking place than you do when you have blunt regulation. And, you don't have a free market system – this is the first solution that we talked about – a free market system where the firm is only trying to serve a single interest. Now, it's serving most of the interests that are affected by the firm.

The question, I think then, is if this is the solution, dear Michael, would it work? Would it be robust? Can firms like these survive?

There are empirical and theoretical reasons to think so. First, empirically we see a great number and great growth rate of these types of firms, where you have broader ownership structure, whether it's in co-ops, B-Corporations in the US, what have you. They're taking off, and they do quite well. And from a theoretical point of view, they should outperform your standard shareholder owned firm.

Why? Well, I'm a strategy guy. And what I look at is competitive advantage and sources of competitive advantage. And what we know today is that, in most firms, the firms that win are the firms that innovate, right? And that can be innovate in process, it can be innovate in a product, it can be innovate in business model, but it has to be about innovation. And innovation is about knowledge. It's about creating knowledge, sharing knowledge, and using knowledge. And so what we know on strategy today, is that firms that tend to win over the long term, are those that create, share, and use knowledge well. And where does that knowledge reside? That knowledge doesn't reside in capital. That knowledge resides in the employees.

So it's critically important for competitive advantage that the employees give their utmost, that they identify with the firm, that they believe in the firm, that they care about the firm, and that they think that the firm cares about them. And I think if you have firms where labor interests are taken into consideration as part of the objective of the firm, you've got a competitive advantage because your employees will be engaged much further.

I'll just briefly go straight here, but it's kind of a strange brainwashing, or blindness I see a lot in the participants – this is my strong... ...I don't want to get fired – but in the participants at IMD. Because we take the standard mantra, as I've mentioned before, is all around shareholder value. And you ask people, employees to work 12-hour days to maximize return for their shareholders. And then you ask them: "Do you care about the shareholders, Max?" "Yes, I'm working my butt off for it." "And do your shareholders care about you?" And when you put those two next to each other, sometimes, there's a look of shock because they say, "Well, no. No. The shareholder doesn't." And I know that it's written into the whole organizational structure that as soon as my net present value as an employee turns negative, well, you should fire me.

So you've got this weird dogma where the employees are supposed to be engaged and supposed to care about the firm, and all this loyalty la-la-la, but simultaneously, we have an ideology that says, use employees as long as they have positive net present value, and after that... well! It's just not part of the system that works.

So, I think, in summary then, just closing up quickly, I think that many of the fundamental problems that we see in society are driven by the economic system. I think capitalism has been a tremendous boon in terms of value creation, but it's spinning a little bit out of control. And we need solutions. I think the three solutions that we've used for the last 30 years are all good, but they're all limited whether it's leaving it to the market, regulating, or socializing. And I think there's a new way to deal with this problem of capitalism.

And that's by changing the ownership and governance structure, to internalize the interests as opposed to trying to push the costs inside through regulation. So I just want to be very, very clear with the few seconds that I have left: I'm not proposing to get rid of markets, I'm proposing that we deconstruct the concept of capitalism.

Capitalism has two main constructs commonly associated. One, is private property market competition, and the other is, capital is the owner of the firm, re-maximize for capital. And I think if you stand back and reflect a little bit, you'll see that most of the benefits that we love about this system, come from this part, from market competition. And most of the problems that we see in society, come from the second part, and that's around the ownership structure. I think we can get the good, while getting rid of that.

Thank you very much.

Citation:

Yaziji, M. (2012). *Rethinking the structure of corporations*. Www.youtube.com; TedxLausanne. https://www.youtube.com/watch?v=8eRwOM9iqVo