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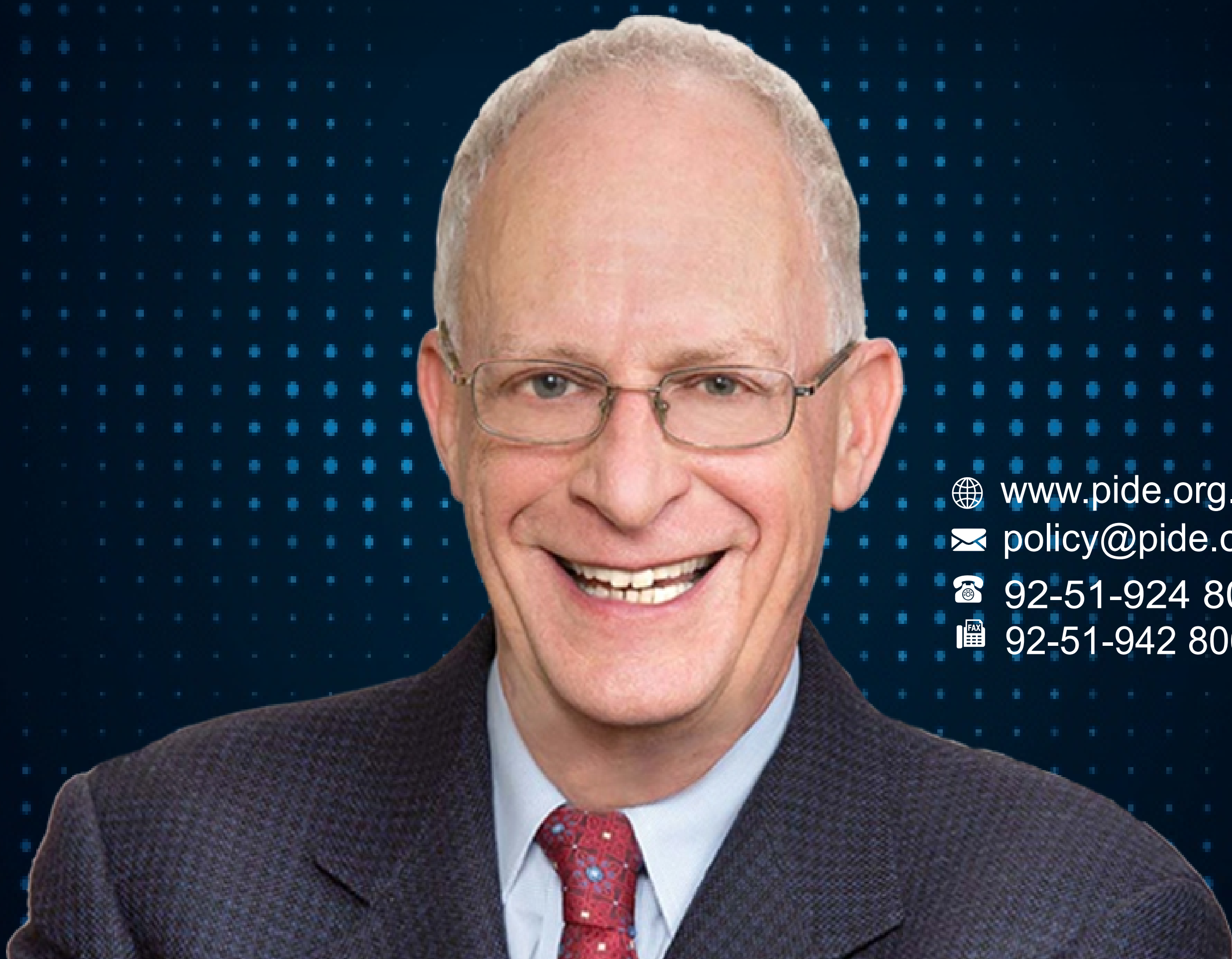
Brief 41:2021

Guest Lecture

A TALK WITH A NOBEL LAUREATE PROF. OLIVER HART ON "VOICE VS. EXIT"



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PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS

PIDE Invited Guest Lecture

A TALK WITH A NOBEL LAUREATE ON
"VOICE VS. EXIT"

April 6, 2021 (Tuesday) at 07:00 PM (PST)

MODERATOR: NADEEM UL HAQUE

GUEST SPEAKER

PROF. OLIVER HART

Oliver Hart is currently the Lewis P. and Linda L. Geyser University Professor at Harvard University, where he has taught since 1993. He is the 2016 co-recipient of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel. Hart's research centers on the roles that ownership structure and contractual arrangements play in the governance and boundaries of corporations. His recent work focuses on how parties can write better contracts, and on the social responsibility of business. He has published a book (Firms, Contracts, and Financial Structure, Oxford University Press, 1995) and numerous journal articles. He has used his theoretical work on firms and contracts in several legal cases. He is a Fellow of the Econometric Society, the American Academy of Arts and Sciences, the British Academy, and the American Finance Association, a member of the National Academy of Sciences, a Distinguished Fellow of the American Economic Association, and has several honorary degrees. He has been president of the American Law and Economics Association and a vice president of the American Economic Association.

Overview of the Debate

The debate commenced with a question which has recently become a hot topic in the U.S and Europe; what could be the suitable objective of a public company. In this regard, almost half a century ago, one of the most famous economists, Milton Friedman, asserted in the New York Times that corporations have just one social responsibility that is to make money for their owners. However, many people do not agree with this point of view of Milton Friedman. As in 2019, the business roundtable which consists of many leading CEOs in the U.S made a statement that companies have a responsibility to stakeholders as well as shareholders. To be noted, Luigi Zingales and Oliver Hart (2017) agreed with Milton Friedman that most of the companies are set up to act on the behalf of the shareholders in the U.S and UK; it means the shareholders are allocated the votes to elect the board of directors. Furthermore, Zingales and Hart (2017) being taken a middle-ground position also stated that some companies are not erected that way; they are worker-owned instead. On this point, they slightly disagree with Friedman and stated that the objective of the companies should not solely be the money-making because shareholders of companies are ordinary people with social and monetary goals and they want companies to pursue these goals on their behalf. Moreover, people are socially conscious, if we take climate change as an example, in an ideal world national governments would agree on the worldwide carbon tax and then everyone could go and pursue their interests. However, we do not live in a world; there are political failures at both the national and international levels. Consequently, individual and corporate actions matter.

On Individual Level

On the individual level, socially responsible people can reduce their carbon footprint, for example, people buy electrical cars rather than gas guzzlers. Zingales and Hart (2017) argued that they may also want companies they own to reduce their carbon footprint as well and they may be willing to sacrifice some profit to achieve this goal. The key point which is not acknowledged by Friedman is that the companies have a comparative advantage in tackling climate change relative to individuals. For instance, an oil company like Chevron is in a much better position to reduce footprints as compared to the shareholders of this company. Back in 1970, companies were talking a lot about the importance of giving charity and Friedman opposed them and suggested that a company should hand that money to shareholders in the form of a higher dividend, and then each shareholder can decide how much of that increased dividend to give to their favorite charity. In contrast, Zingales and Hart (2017) consider Friedman's argument as a compelling argument in the case of charity contributions; the reason is, companies do not have a comparative advantage in giving to charity as charitable contributions are separable from ordinary business activities.

How shareholders influence a company to be more socially responsible or environmentally friendly?

In practice, there could be two ways: exit or voice. It means shareholders can EXIT or leave the companies with a high carbon footprint by divesting. They can deny buying shares in the first place or if they have shares they will sell them and expect that perhaps the share price of the company will go down and a profit or value-maximizing company will take notice and decide to become cleaner. Consumers and workers can also pursue exit strategies by boycotting products and refusing to work in the dirty company. Another unique possibility that shareholders have is to use their VOICE by using their voting power as they have the votes and they can use them to push the company in a socially responsible direction. In a recent working paper, Eleonora Broccardo, Luigi Zingales, and Oliver Hart compared both exit and voice strategies theoretically.

How does voice work?

In this paper, a simple three-date model is presented to show how the voice works. First of all, they considered a private company which is initially 100 percent owned by a founder F and not yet traded on a stock market but planning to do so because F is going to take the company public. There is going to be an IPO, an Initial Public Offering and authors supposed the founder F sells her entire state to the public and she is going to retire and have no longer financial interest in the company. They supposed that at date 0, in 1970, she sold all her shares to a large number of shareholders. Now this company is expected to make a profit equal to 100 at date two. Surprisingly, at date one, it is learned that climate change is a problem, let's say in 1990 or 2000 and this company is going to cause environmental damage equal to 30 which is measured in money terms. Likewise, they supposed that the direct effect of this damage on the shareholders is minimal but the aggregate effect is sizable, which is 30. Once again, they supposed that the company can avoid this damage by changing its operations by spending 20 (in money terms). Now the interesting question is whether the company is going to do it or not. For this, imagine that this is decided by a vote of the date 1 shareholders. Further, suppose that each shareholder is somewhat socially responsible in the sense that when she makes a decision she puts weight (l) on the welfare of the other people affected by the decision. Thus, well-diversified shareholders will vote for the socially efficient outcome even if they are just slightly socially responsible.

Takeaways

Divestment (exit) is less likely to be effective. The reason is that even if a majority of investors are socially responsible, the incentive of purely selfish or mildly responsible investors to buy the shares of those divesting is great, dampening the fall in share price. As a result, companies will not respond much. However, divestment or consumer boycotts can be effective if they change social opinion (Fur-free campaign).

To recapitulate, the voice should be encouraged much more than it is. Currently, there are lots of restrictions on a voice that could be relaxed; however, the voice will not work with majority-owned or private companies. Moreover, companies ought to listen to their owners and consult them about how much profit they are willing to sacrifice for a cleaner environment. The same is true for asset managers; they should consult their investors.

Implications

- Activists should perhaps rethink their strategies.
- Students at Harvard and elsewhere have pushed their universities to divest.

Q & A Session

1. What about the problems of commons as far as diversified concerns?

The way this can happen in practice is that there are large shareholders these days, which are institutions. They have many large investors for example BlackRock, State Street, and Vanguard which have about 15% of many American companies. It is not difficult for BlackRock itself as its CEO personally does not have a large share he is representing many small investors but he can certainly solve the problems of commons by putting it on the ballot.

2. What kind of regulation do small nations put in like Pakistan to make the voice work better?

Based on the American experience, firstly, countries like Pakistan should get rid of any regulations that make it difficult to express voice. Moreover, companies should start thinking about being encouraged to consult their shareholders.

3. How would the results of the study generalize to democracy, for example, in a sense the parliament as a board of directors and the rest of us are like diversified shareholders?

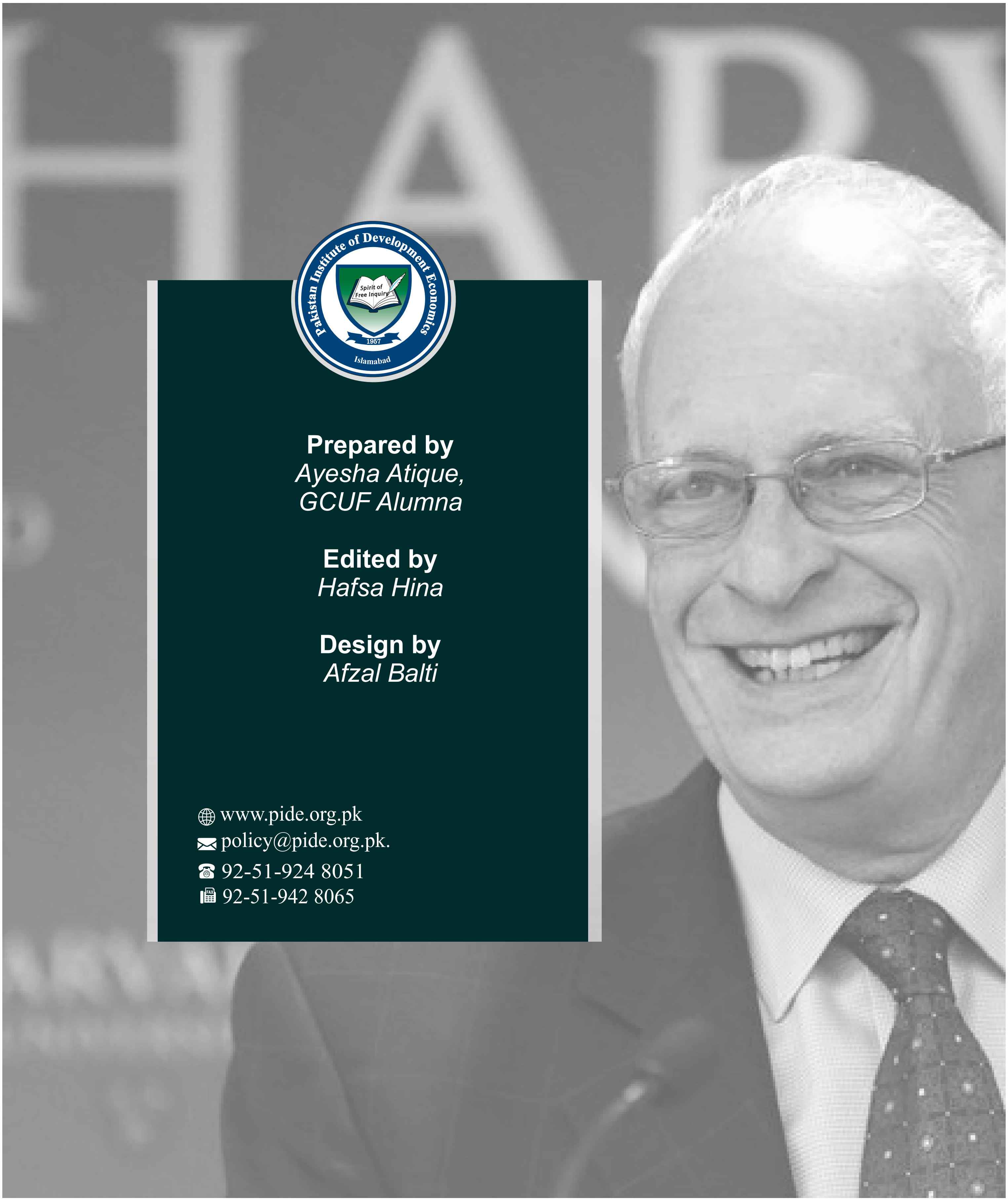
This perspective suggests that having more referendums is a good thing.

4. If we see the issue from the real-world perspective, how far the idea of divestment works because it may raise the issue of employment and reduction in income level.

If companies become cleaner or greener, some people worry about the employment implications of that. However, on the other hand, of course, there are new technologies where people can also be employed.

5. What is your opinion when it comes to individual investors? Are they aware of when information is misrepresented?

Yes, greenwashing undoubtedly happens but we need to understand why it happens. Some people are aware of it and the ways to deal with it. Such as by disclosing information that is false presumably there should be some penalty for that.



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