Towards a New Model of Wealth Creation:

Shareholders and Stakeholders

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Abstract

There are currently two distinct approaches to a capitalist model of free enterprise. The first is the Shareholder Model. In this approach the prime purpose of the economy is to enrich individual shareholders. All other activities like satisfying customers, developing employees and rendering the company more innovative are means to the end of profit maximization. In the second model the several stakeholders, employees, customers, shareholders, the community, the supply chain, banks, the government and the environment are all believed to have a stake in the output of the business and the outcome of its policies. Such policies should benefit the entire range of stakeholders. This article argues that the second model leads to faster economic development and better all-round outcomes than the first

Introduction: Two Rival Models

The recent financial crisis has sent shockwaves through the academic community, at least among those of us who are fully awake. Two models of free enterprise are vying for supremacy and the collapse of major parts of the financial sector have set back the paradigm that was once dominant and has boosted its rival, so that there is now a serious contender. These two models are the Anglo-Saxon Model of free enterprise and the largely Asian and mid-European stakeholder model. The Anglo-Saxon Model is especially strong in the UK and USA, the two nations pioneering the industrial revolution and using the English language to promulgate their views on a global scale. Australia, Canada and New Zealand are also disciples of this view. The major discipline involved is economics, urging the views of Adam Smith, Milton Friedman (1962) and the Chicago School and implemented up to the recent financial crisis by Alan Greenspan. The model's current rate of economic development is very slow. These nations have generally suffered much more from the financial crisis.

The alternative view is the Asian Stakeholder Model, which is popular among those nations fast-following Britain and the USA. This approach was at first typified by Germany, France and Scandinavia in the 20th century. These used industrial banking to chase the leaders and succeeded in closing the gap in most instances. Today the prime practitioners of the Stakeholder Model are Japan, South Korea, Taiwan, Singapore, Hong Kong and more recently, the PRC. This model conceives of wealth creation as an

alliance of stakeholders: employees, customers, network partners, shareholders and banks, the government, the community and the natural environment. Its potential discipline is organizational studies and human behavior in organizations, since this discipline deals with relations between various national constituencies. Its rate of economic development, on average, is much faster and these nations rebounded much better from the crash of 2008. The two models contrast as follows:

Anglo-Saxon Shareholder Model	**Asian Stakeholder Model**
1. Maximization of shareholder returns is unambiguous.	Optimization of stakeholder returns is fuzzy and ambiguous.
2. Benefitting employees, customers and suppliers are the means to shareholder enrichment. The company is owned by its shareholders who are entitled	Stakeholders are not automatically benefitted when shareholders gain. The parties must negotiate and share gains, and do ever more to support each other. .
3. The purpose of business is the private enrichment of individuals.	The purpose of business is see that a whole community learns and improves.
4. Industry is a means to profiting. This is the ultimate end, the bottom line.	Industry is meaningful in its own right and profits keep it going and growing.
5. The whole idea is to make money, which banks do very well by lending out and directly leveraging	The whole idea is to create wealth, which involves benefiting customers and reaping rewards indirectly.
6. Shareholders come first. The money they invest makes everything else possible and all other participants must reward them. They make everything else possible	Shareholders come last. First managers must motivate employees. Employees must satisfy customers. Customers generate revenue and only then do shareholders benefit.
7. New businesses are mostly started by venture capitalists.	New businesses are mainly started by extended family savings.
8. Innovation is the work of redoubtable, fearless individuals who defy received opinion.	Innovation is the work cohesive, enterprising communities who build networks of mutual trust.
9. Manufacturing is better outsourced to cheaper locations so that shareholders benefit from this.	Manufacturing is the heart and integrity of the stakeholder enterprise and the only hope for our poorer citizens.

10. Governments should intervene as little as possible. They only distort the operations of the free market. Weapons and space exploration are exceptions.	Only governments can look far enough ahead to save the planet by sustainable energy and preserve the environment. Why spend only on killing?
11. The main hope for poor countries (e.g. Africa) is to allow America shareholders to own most of their infrastructure and raw materials.	The main hope for poor countries (e.g. Africa) is to let the Chinese build their infrastructure in exchange for access to their raw materials.

(China spends more in Africa then the entire European Union)

There is growing evidence that the stakeholder model is producing far better results for its advocates. We believe that this is a signal for those specializing in subjects like Human Behavior and Organizations to rise to the challenge and support this model, providing an alternative approach to economics. Let us consider the points made in the boxes above one by one.

The Literature Review

We will now go through points 1-11 and survey the relevant literature.

1. Maximizing shareholder gains is unambiguous

One strong reason for the maximization model is its clarity. You can tell precisely how much money is being made by whom. But gains shared among stakeholders are unalterably fuzzy. How can you estimate mutuality? What does a community gain from a local employer? It may be true that employees "learn" but what does that amount to? The popular English expression "it does not count" speaks volumes. If you cannot sum it and express it numerically accountants will tend to ignore it and economists reaching for the mantle of "science" will deplore its imprecision. "The bottom line" is a specific, as if "head-hunting", bullet points, objectivity and "firing" people as if they were bullets in a gun. The poet Auden described the American Southwest in the verse that follows.

> "Come to our well-run desert
> Where anguish arrives by cable
> And the deadly sins may be bought in tins
> With instructions on the label"

Fons Trompenaars (1992) and Trompenaars and Hampden-Turner 1997) refer to this as a "Specificity bias". There are specific thinkers in the USA and the UK and diffuse thinkers, most pronounced in East Asia. Most Chinese regard wealth creation as the result of relationships and connections, to be "wealthy" is to be "well connected". *Guanxi* means not just relationships between people but between ideas, concepts, bodies of knowledge and between Yin and Yang in Taoist philosophy, see Haihua Zhang (2008)

and Ming-Jer Chen (2001) The Chinese see the connections between stakeholders and their ideal is harmony between these as befits the Middle Kingdom.

2. **Employees**, **customers and the community are the means of shareholder enrichment**

What the shareholder model does is to make employees, customers and the community into mere means to the enrichment of equity owners. It is fine to serve customers and to train, educate and develop employees but the reason for doing these things is to make shareholders wealthier. If the shareholder is *not* made wealthy by such activities these should cease. If declaring employees redundant, outsourcing manufacturing, reducing assets and/or reducing costs does more to increase the share price then this should be substituted for growing the workforce or learning new skills.

One result of this policy is to make shareholders richer and employees poorer. Robert B. Reich (2011) has shown that the top 1% of wealthy individuals in the USA now own 24.8% of total income, mostly in the form of shares or bonds. Only once before in America has inequality been so marked, in 1929 on the eve of the Great Depression when it stood fractionally higher! John Maynard Keynes (1938) highlighted the problem. If a person of poor or medium income earns more, this will immediately re-enter the economy in the form of new purchases, but give this money to the very rich and they will either save it or use it for speculative purposes. Moreover giving so much to the very top earners deprives the middle class upon whose industry as stake holders the entire economy depends.

3. **The purpose of industry is the private enrichment of individuals**

We handicap our own economic growth if we measure only what has been taken *out* of industry and not what we have put *in.* What is given to shareholders must be subtracted from the rewards to employees and it is they who do the producing and innovating, if indeed any of this is to occur. Shareholders can be described as people who do not share! Fons Trompneaars (2008). They may not know in what companies their money is invested, may keep it there for a matter of hours only and buy other shares to make short-term gains. Like absentee land-lords they are separated often by great distances from what they own. Culture shocks like a hostile take-over or mass lay-offs that cause share prices to jump may bring other stakeholders only grief and disruption.

There are many ways of boosting the share price which may do other stakeholders no good or actual harm. Buying back your own shares will cause a temporary blip, enabling holders of share options to cash in but does nothing for the prospects of other stakeholders. It is extremely unlikely that fewer workers will do a better job. In the meantime the salary costs saved find their way into shareholders pockets. If you buy a company you can order it to borrow heavily and give the proceeds to shareholders. Even if that company eventually succumbs beneath its load of debt, the temporary boost in dividends has raised the share price with the consequences will come much later, before which the shares are unloaded.

There is increasing evidence that we *learn as knowledge communities* Peter Senge (1989) how to produce and innovate better and *build core competence,* Gary Hamel (1989). yet shareholders are in no sense a community, nor do they have shared knowledge of the businesses in which their funds are invested, nor is their interest long-term save on a very few occasions. The life-spans of corporations are less than the life-spans of individuals, a fact that reveals our priorities. Lehman Brothers is dead but Dick Fuld, architect of the disaster, is very rich indeed, John Gray (2010)

4. **Industry is a means of profiting. The ultimate end is the bottom line**

The problem with this doctrine is that the very word "end" suggests we then stop having reached goal, but creating wealth is a *never ending process.* Profits need to be ploughed back so that industry expands. Too much emphasis on harvesting gains will slow growth down. There is also the problem of morale. Do we seriously expect workers and managers to rejoice over making money for people they do not know and have mostly never met? Do you embrace you spouse on your homecoming and happily announce that you made even more money for shareholders today? Is it not truer to say that industry is *Heart Work* as Chan Chin Bok (2002) put it, that much of our work is its own reward shared with customers and community?

One problem with valuing profitability above all else is that our competitors will give this to us while taking the rest of the pie for themselves. Thus Clayton Christiansen (2009) explains how Flextronics, a humble Singapore sub-contractor, got the best of Compact, the one-time Texan computer-maker. They had long made the circuit boards for Compact but then asked to make the motherboards as well. They could do this for 20% less which would boost Compacts profits, so Compact agreed. The same logic led Compact to give them first assembly, then logistics and supply chain management and finally the design of the computer itself. All these tasks were handed over and after every deal Compacts profits climbed, especially their asset-profit ratio since they had given away most of their assets! There was only one problem. Flextronics had captured most of their core competence and held all the aces. Compact was later sold to Hewlett Packard.

5. **Making money by direction and by leveraging or indirectly via others**

You can make money directly by lending and leveraging, a favorite tactic of banks and finance houses, or you can make money by *indirection,* by first doing something for the customer and allowing him or her to repay you. Stake holders make money by supplying each other and paying for this later. Bankers tend to make money by direct manipulation of the market. By far the commonest way of doing this is by leverage that is by lending out multiples of what you have yourself borrowed. If you forbid your clients to leverage more than four to six times, while leveraging your own funds thirty times then this considerable difference is pure profit *provided the price of assets keeps climbing.* Unfortunately this is not genuine wealth creation. It is not even a lever for creating wealth as the metaphor implies. It is rather a "magnifying glass" that increases profits AND

LOSSES and tips us over the precipice when asset prices fall. This is what happened in the latest crash, Paul Mason (2009)

6. Shareholders come first, or is it last? Their money makes all else possible

The view is that shareholders put up the money which makes everything else possible. Since they started the process it rightfully belongs to them for ever. The word "organization" is from *organon* meaning "instrument". The organization is the shareholders instrument for making money and they can use it as they wish. If they use it rationally and wisely it will serve them well and generate a stream of profits.
They provide the money and the rest of us pledge our working lives, a bargain which on reflection is somewhat uneven, see Thomas Frank (2001).

But is this view correct? Most businesses become publicly held corporations only *after* they have succeeded and made an Initial Public Offering which shareholders take up. They actually start with no money at all, just an idea. The would-be supplier approaches a potential customer and if a deal is struck the company is born. Arguably it is stakeholders who start the whole process going, suppliers, employees and customers. One extremely successful US corporation which has been *very* good to its shareholders over seventy or more years is Johnson and Johnson, originally a family-owned company. The company's credo, originating in 1942 is "Shareholders come last" see Jim Collins and Jerry I Porras (1994). This does not mean shareholders are least important. It means shareholders come last *in time.* First managers must motivate employees. Second employees must serve customers. Third customers must buy more from this supplier and *only then will a surplus be generated from which shareholders can be paid.* The irony is that J&J has treated its shareholders better than almost any other US company over the years and that sharing your gains with other stakeholders *is in the interests of shareholders themselves.*

Popular approaches to organizational development like the Balanced Scorecard of R S Kaplan and D P Norton (1992) appear to take the presence of stakeholders for granted and to regard a balance between these as desirable. They generally avoid discussing the politics involved in giving the financial perspective a dominant role. They do point out that the shareholder view faces *backwards* in time to what has been accumulated up to this time. This does suggest that grabbing the lion's share for shareholders is suboptimal.

7. New businesses are mostly started by venture capitalists

The popular notion that venture capitalists start new businesses is only true in a minority of cases. By far the most common form of new business is family firms started in a networked communities who undertake to buy from each other. The GEM studies produced by Babson College and the London Business School show that the commonest reason for new business start-ups is *necessity*, the need to survive. The self-fulfillment of the individual is secondary although not unimportant, especially in the West. Several scholars are now making the case that even innovation, or Open Innovation as they call it,

is the work of networked supply chains, see Henry Chesborough (2010) Wealth is generated by whole systems not so much by individual firms.

8. **Innovation is the work of redoubtable, fearless individuals**

The shareholder model insists that company's exist because the fearless individual who started it all. In the beginning he or she owns the company and is joined by other shareholders. The community, so called, plays a minor role. If we undermine the sovereignty of the founding individual we will lose the whole plot. The drive comes from the individual owner.

But how true is this? We know from Everett Hagen (1967) that 50% of all entrepreneurs in Britain's industrial revolution came from Nonconformist sects. David K Hurst (1995) points out that English Quakers out-performed the populations as a whole *forty times over* in wealth creation. In the Philippines at this time a 3% Chinese population owns 70% of that nation's wealth with similar proportions elsewhere in South East Asia. The capacity of certain immigrant communities to create wealth is legendary. After Singaporean Chinese were expelled from the Malaysian Federation their new nation grew four to five times faster than Malaysia, where a 31% Chinese population controls 71% of the wealth Ming-Jer Chen (2001). All of this suggests is that wealth is created by *communities and their norms which favor enterprise.* In short stakeholders do it together.

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9. **Manufacturing is better outsourced to cheaper locations, so that shareholders benefit**

One of the most serious consequences of placing shareholders ahead of all other stakeholders is the habit of outsourcing much of our manufacturing to work forces abroad. If we *wanted* these to prosper and overtake us no better strategy could be devised! Gary Pisano and Willy C Shih (2009) have tracked the decline in the US balance of payments in High Tech. from $27.8 billion in surplus in 2000 to $53.8 billion in deficit by 2008., since when it has deteriorated further. They trace the decline of the US *industrial commons,* the pool of community-based skills within America in the vicinity of its major companies, in other words stakeholders.

When you outsource say- battery technology to China for making electric cars, you thereby sacrifice the whole industry, because the performance of the battery is the key to the success of the car and countries that have a skill-pool able to fit better batteries into improving vehicles gain competitive advantage. Innovation often comes from rearranging thousands of incoming components and manufacturing is the hub of this convergence. Certain key components, especially in electronics can give rise to successive industries. They are its building blocks. Outsource these and you have given way the very context of innovation itself. The American tax-base needs the salaries that were once paid to managers and workers.

10. **Governments should intervene as little as possible, leaving it to free markets.**

One of several stakeholders is the government and those who advocate shareholder sovereignty also advise that the government stay out. The problem with this view is that the USA has always prospered most at times when the government most interfered. The Great Prosperity lasted from 1947 to 1975 and this coincided with *massive* government expenditures. The Cold War gave the USA the largest command economy ever known, while space took up as much as 4% of total GNP. Federal spending on education doubled in the years after Sputnik. Money was shoveled at social problems to prove that our society was superior to the Soviet Union and cost-plus contracts were a substantial boost to innovation. Robert B. Reich (2011)

It was when the Cold War ended and government contracts were cut back that the problems were exacerbated. Similarly the Great Depression was ended by preparations for World War II. Americans have always been prepared to spend on defense but not on new threats to the planet, like global warming, food and water shortages and the urgent need for renewable energy. That China has seized a 75% world share of solar energy technology and Germany is moving out of nuclear energy shows us that governments are taking bold leads in this area, where shareholders see only costs to be avoided, Paul Mason (2009). Can we leave the fate of the planet to shareholders?

11 The main hope for poor countries is to allow American shareholders to own most of their national assets and infrastructure

Nations have severe difficulties with economic growth unless this is home-grown, arising from the enterprise of its own people. One reason that so many economies followed the Soviet path to economic development, despite repeated failures was that this at least empowered the nation state by making its government responsible. One reason for the prosperity of first Japan, then the Pacific Rim and then China was their *very high domestic savings rates.* Capital could be supplied by their own people to make their domestic industries strong. They were prepared to accept the market under those circumstances. Countries without substantial savings faced the problem of becoming dependent on foreign shareholders, largely American.

It is no coincidence that “catch-up economies” see Charles Hampden-~Turner and Fons Trompenaars (2000) are virtually all stakeholder economies. There is some inward investment but this is a small proportion of the total. Nations need to take responsibility for their own growth and governments lead in this in process, acting as “Coaches” in addition to being “Referees”, see Bruce R Scott and George C. Lodge (1985) The “coach” as in football is often popular, but the “referee” is rarely so, making it difficult for Western governments to lead save in national emergencies. The example of China’s policy towards Africa where it exchanges infrastructure development for access to raw materials is an interesting development of the stakeholder approach.

Discussion and Conclusion

There is mounting evidence that the traditional shareholder model of capitalism is being challenged and is giving way to various associations of stakeholders. Despite their

relative benefits being hard to assess the stakeholder model distributes gains more widely than the shareholder model and recognizes that all parties need to work together for economic development to occur. That what shareholders gain trickles down to others is not established and is doubted. No party to an enterprise should be treated as a mere means to enrichment. Rather than industry being activity leading to profit, it may make more sense to see profits as something to be bestowed on industry and on industrious people. Industry is an end in itself.

Genuine wealth is created by *indirection,* by first benefitting another stakeholder who repays you. Shareholders come last in the sense that stakeholder activity must precede a division of spoils. There is mounting evidence that innovative enterprise is a group activity, a form of improved relationships among stakeholders in networks using shared knowledge as their medium. Manufacturing is the integrity of this network and we outsource at our peril. Governments are needed to regulate and lead associations of stakeholders and give these a democratic direction. World environmental crises necessitate such leadership. Poor countries are unlikely to develop economically unless their growth is spurred by their own cultures and unless they own their own destinies.

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