Corporation 20/20
Designing for Social Purpose

# THE PURPOSE OF THE CORPORATION: ADAM SMITH REVISITED

**A Workshop Co-Organized by**
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**Keynote Remarks**

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Ladies and Gentlemen:

It is an honor to welcome this distinguished group of participants to this workshop and to share a few opening thoughts concerning the theme of our event—the purpose of the corporation. Organizing this event with the Chatham House team—Richard Tarasofsky, Lorraine Howe, Gemma Green and, most especially, my good friend and colleague, Paul Hohnen, has been a privilege and a pleasure.

That we are assembled here today to discuss a question as fundamental as the purpose of the corporation strikes a chord of curiosity, perhaps even astonishment. The corporation has evolved over the last two centuries, yet its core purpose still remains ambiguous. With this in mind, why then does the question of corporate purpose rarely appear in the multitude of conferences, seminars and workshops on business-society issues? It continues to be the proverbial gorilla in the room, quietly taking much space but so weighty that most choose to leave well enough alone.

It is, indeed, ironic that the purpose of the most powerful and influential of human creations—the joint stock corporation—remains so contested. The irony stems from the reality that purpose is integral to minds and behavior of business leaders and corporations they lead. We simply do not have a generally accepted set of rights and obligations for corporations, much less principles or a constitution, to relieve the prevailing ambiguity surrounding corporate purpose. In a globalizing world, such a vacuum is a recipe for tension and stress in business-society relations, which is exactly what one sees in today's world.

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While corporate purpose is contested, I do not mean that corporate purpose is headline news in the daily business press, nor a priority agenda item for corporate boards, nor the subject of government inquiries. What I do mean is that *underlying* these activities, and many others concerning the operations, governance and regulation of the corporation, is a tension between how corporations, shareholders, and society define the purpose of corporations.

Indeed, the emergence, struggle and denigration of the corporate social responsibility (CSR) movement mirror this tension. For some, CSR is an overdue mechanism to ensure that the corporation is an agent of long-term, societal wealth creation. For others, CSR is an unfortunate, even damaging, digression from business' focus on shareholder value, a view articulated in the now infamous *Economist* piece in January 2005, titled "The Good Company."

Stepping back from the details of any particular situation, we see that the last decade has been an unsettled period for corporations. While recent incidences of misconduct have roiled investors and markets, stakeholders continue to press corporations to attend to this or that interest amidst targeted efforts to reform corporate governance and elevate standards of accountability. But one cannot help wonder whether tweaking governance—be it redefining the purview of financial statements, elections, composition of directors, or changing the makeup of audit and compensation committees—misses the point. One might well ask: Should the core purpose be better articulated, clarified, understood or perhaps even redefined before its governance structures are further revised?

It is this question that motivates the remarks that follow. They are offered in the spirit of provoking discussion among panelists and participants, not as a comprehensive chronicle of all that has been said about corporate purpose.

**What Would Smith Say?**

Imagine for a moment that Adam Smith were with us here today and was asked to join us in exploring the purpose of the corporation. We know this great moral philosopher harbored deep reservations about the joint stock company that was emerging in the late $18^{th}$ century. Indeed, it was no accident that he spoke of the "wealth of nations," not the "wealth of corporations."

Smith distinguished between those who live from rent (a measure of wealth generated by tapping natural resources) and wages (wealth generated by work) versus those who live by profit (the assumed goal of business). This distinction becomes crucial when evaluating each sector's impact on society. Business logically and inexorably seeks to create monopolies or semi-monopolistic conditions for profit-making purposes. According to Smith, to the degree it succeeds, society is less, not more, prosperous. This is why profit is "…naturally low in rich and high in poor countries.…"

Smith saw the propensities of corporations as central to forming and perpetuating monopolistic conditions, inclined to retain profits rather than invest them in innovation, and maintain monopolies through whatever means possible, including, as he put it, "intimidating the legislature." He held a gloomy view of the shareholder-controlled corporation, believing that shareholder domination—versus the partnership corporations wherein the owner-manager relationship is continuous and closely interlinked at the operational level—was a recipe for profit-taking at the expense of the greater good. For Smith, the experience of the East India Company exemplified the inevitable anti-social behavior of unchecked corporate monopoly and power.

In short, it is fair to say that Smith's view of the role of the shareholder-dominated corporation was unflinching and grim. It is a view that, remarkably, rarely surfaces in the endless debates about the vices and virtues of market capitalism. While Smith's brilliant insight regarding the invisible hand is accorded virtually divine status, his other equally seminal insights regarding the behaviors and consequences of joint stock corporations remain decidedly underplayed. By almost any standard, this amounts to a selective and biased reading of the insights of one of the great minds of the last two centuries. A more balanced reading of the *Wealth of Nations* sees that Smith was both a moral philosopher and a macro political economist, far more concerned with the money, prices and capital, rather than the purpose, of the corporation.

If Smith were part of our discussion today, he might be shaking his head with a mix of self-congratulations and distress that his anxieties were, in fact, well founded.

Why is this the case? Three reasons come to mind. The first is **scale**. The reach of today's largest corporations exceeds even the vivid imagination of a mind as grand as Smith's. We now witness companies—WalMart, Exxon Mobil, BP, Shell—with revenues in excess of a quarter *trillion* dollars ($US), a turnover inconceivable two decades ago, much less two centuries ago. Half of the largest economic entities in the world are corporations larger than the nations whose wealth was the focus of Smith's inquiry. With such tremendous scale comes domination of vast networks of suppliers, millions of workers, and the exercise of enormous influence in terms of pricing, labor conditions and community impacts. With little doubt, Smith would be wondering, as many others do, whether such corporate influence is being matched by commensurate standards of moral and legal responsibility.

A second reason is **transience.** Always uncomfortable with the severance of ownership and management, Smith likely would be no less than astonished by cycles and waves of mergers and acquisitions, fleeting ownership—sometimes measured in seconds—enabled by new investment instruments such as hedge funds, and dislocation associated with frenetic restructuring of where and how goods and services are produced. Observing the immunity of shareholders and repercussions on workers and communities would leave Smith feeling vindicated.

Finally, **disparities** associated with the corporation would also provide Smith with a dose of consternation. Disparities, of course, come in many forms—from the macro level across nations to the micro level in the form of widening earnings disparities between shareholders and other stakeholders, executives and workers, financial intermediaries and those who actually create—rather than manage—wealth. For a moral philosopher of Smith's orientation, the picture would not be heartening.

Scale, transience, and disparities are attributes of the corporation that in one form or another left Smith uneasy about the drift of corporations as he perceived it in the late 18$^{th}$ century. He was, it turns out, as much a student of the future as a moral philosopher. Of course, he could not, or chose not to, explore the creative genius and innovation of corporations that would unfold in the decades after the Wealth of Nations. But this, after all, was not the purpose of his inquiry to begin with.

**Unfinished Business**

Judicial decisions in the late 19th century that gave rise to shareholder supremacy firmly entrenched the notion that corporations are entitled to the rights and protections of natural persons and, moreover, shareholders are the principal recipients of the surplus associated with corporate wealth creation. Together, these two notions are the foundation of the modern mantra of "shareholder value" as the de facto purpose of the corporation.

Observing today's business environment, one may easily forget that some early industry titans dissented from this view. Henry Ford, founder of Ford Motor Company, and Owen D. Young, GE's chairman in the 1920s, questioned the supremacy of shareholders relative to other parties that contribute to corporate wealth creation. Ford once was sued by two shareholders for suspending dividends in favor of plant expansion. When asked the purpose of his corporation, he responded: "To do as much good as we can, everywhere, for everybody concerned … and incidentally to make money." Ford lost his case in a Michigan court.

A few years later, Young rhetorically asked: "To whom do I owe my obligations?" His answer: "The company owes `a fair rate of return to shareholders' at the same time as it serves the interests of employees, customers and the public." Ford's and Young's observations, it turns out, were precursors to what we label today as the many variants of CSR that see corporate purpose as long-term wealth creation for a broad range of constituencies, including, but not limited to, shareholders.

Echoes of Ford and Young are not entirely absent in the early years of the 21st century, although one must look outside the Anglo-American world to find many of them. Mr. Katsuaki Watanabe, CEO of Toyota, the world's most valuable and profitable carmaker, remarked in a July 2005 speech:

> *"Sales volume and market share are not important…What's more important is improving the quality of our cars and service. My dream is to build a car that cleans the air as you drive it, and causes no accidents."*

Tata Industries, among India's largest corporations, continues the Gandhian–influenced leadership philosophy of its founder, J.R.D. Tata, that aligns the corporation with a larger sense of community employee leadership. He once said:

> *"To be a leader, you have to lead human beings with affection."*

In a complementary vein, the seminal South African King Commission on Corporate Governance, arguably the most forward-looking governance framework yet produced, stages its framework on the foundation of "Ubuntu," the ancient African principle that humanity toward others is the underpinning of society. Prepared under the aegis of the South African Institute of

Corporate Directors—hardly a fringe campaign group—the report depicts a corporation's social purpose as inseparable from its financial purpose. The subordination and embedding of corporations in the fabric of society coupled with the parity between shareholder and non-shareholder interests comprise the central message of the report.

Closer to home, major corporations today in their mission and vision statements frequently refer to a purpose that transcends shareholder enrichment. A pharmaceutical company may speak of its transformation into "wellness companies," an automaker into a "mobility company," an oil company into an "energy company to light, space condition and move the world," and an Internet company into an "organizer of the world's information." And while many observers understandably lament the slow uptake of the UN Millennium Development Goals by the business world, in fact numerous examples of corporations in their social and sustainability reports reference the MDGs as a beacon to inspire and a yardstick to measure their contributions to sustainable development.

At the macro level, governments explicitly and implicitly have chosen to view corporations as instrumental to achieving a greater public purpose. Since World War II, Asian nations such as Japan, South Korea and Malaysia have protected their companies in an effort to accelerate post-war economic recovery and establish a firm footing to compete in the global economy. India under Nehru practiced similarly active statist policies, viewing indigenous companies as national resources that need careful cultivation and protection. China's emergence—now virtually complete—as a global economic tiger, is occurring with substantial government control and subsidy in key sectors such as banking, putting the country's economic and geopolitical clout ahead of shareholder interests.

In Europe, protection of key sectors from external competition—agriculture, apparel and pharmaceuticals, for example—is more a policy of EU-wide economic objectives than shareholder enrichment. And the recent US government intervention in the proposed Chinese acquisition of the UNOCAL, a mid-size US oil company, is a demonstration of geopolitical, not shareholder, interests. None of these examples is intentionally antithetical to shareholder interests. But, collectively, they represent a landscape in which governments do not hesitate—for better or worse—to harness corporate interests in service to a greater public interest.

**Shareholders Supreme?**

The picture today of corporate purpose is fraught with ambiguity. Inside the corporation, notwithstanding the high aspirations spoken by business leaders, near-term capital pressures and shareholder interests remain powerful—arguably the most powerful—determinants of strategy and management decision-making in publicly traded companies. The culture of "stock market capitalism"—the unwavering focus on short-term share price at the expense of other performance indicators, including payment of regular and attractive dividends—brought shareholder primacy to its pinnacle by the 1980s. This was evidenced during the wave of mergers and acquisitions (M&As) that swept the business community in the name of maximizing short-term shareholder value. Though the long-term benefits—even to shareholders—of the waves of M&As remains highly debatable, the period solidified the supremacy of shareholder returns over returns to other stakeholders in the company. While emphasis and vocabulary may vary, the ascendance of shareholder primacy occasions modulation, if not negation, of even the aspirations of corporations, including those with the deepest commitment to public benefit.

Outside the corporation, a different picture emerges. Governments, in which the authority to create and regulate corporations resides, have not been timid about harnessing corporate activity to achieve a broader public purpose, be it geopolitical, social or economic. Trade preferences, subsidies, preferential procurement, R&D support and outright whole or partial ownership of enterprises remain commonplace in both the global North and South. While few governments overtly contest shareholder interests as paramount and, indeed, most reinforce it in securities law and regulation, their actions speak louder than their laws. Public purposes such as jobs, security and even prestige weigh more heavily than shareholder interests when tough decisions confront policymakers.

For civil society, shareholder primacy is by and large viewed as the root of much that needs correction in the realm of corporate governance and conduct. When this community speaks of the stakeholder model of governance as preferable to the shareholder model, the inspiration stems from the view that sources and beneficiaries of wealth created by the corporation are fundamentally incongruent. Doctrines and models such as "team production," wherein wealth creation is viewed as the result of joint and inseparable outputs of all participants in the firm's activities—managers, workers, communities, suppliers and, yes, shareowners—underpin much of civil society's discomfort with the drift of the contemporary corporation.

The solution is to reconstitute the corporation and, by implication, its purpose, to reflect a more balanced input/reward ratio that acknowledges shareholders and non-shareholders alike as "investors" in the corporation. Such views find camaraderie in the thinking of scholars such as Sumantra Ghoshal, formerly of the London Business School, who sees "gloomy" management theory and "radical individualism" as responsible for corporate amoral, shareholder-centric behaviors. Ghoshal asks: "If the value creation is achieved by combining the resources of both employees and shareholders, why should the value distribution favor only the latter? Why must the mainstream of our theory be premised on maximizing the returns to just one of these various contributors?"

**A Moment in Time**

Whatever one's proclivities in these debates, it is difficult to deny that at this moment in time—in the opening years of the 21st century—old doctrines and mindsets regarding corporate purpose merit serious reflection. One cannot disregard the extraordinary wealth that corporations have generated since they took shape in the late 18th and early 19th centuries. Instead, we ask a different question: what is the corporate purpose and associated corporate forms that we need to meet 21st century—not 20th and 19th—needs and expectations? The world is simply too complex, too interconnected and too fragile *not* to ask such questions of one of its most powerful institutions. Global institutions such as the United Nations are subject to the test of relevance and efficacy—why not corporations?

This challenge in normative thinking animates Corporation 2020. In Spring 2004, a group drawing from business, law, labor, finance, government and civil society communities convened for the first time to begin exploration of these questions. The group posited, if we were charged with the mandate to design the corporation of the future that would meet societal expectations and needs in the coming decades, what would it look like in terms of its charter, governance, directors duties, ownership, capitalization, liability and other key attributes? What are the design principles that should guide this new architecture, and what is the range of actual designs that may be built based on these principles? Normative, creative, yet pragmatic thinking is the thread that binds the process.

Since the Corporation 2020 initiative was launched, a small but growing circle of participants has contributed to the dialogues, visioning and advocacy activities. Some participants are frustrated refugees from the CSR community, sensing that the CSR movement may be reaching its inherent limitations as a force for positive change. Others are engaged in parallel initiatives, including law reform inquiry of the Joint Committee of the Parliament of Australia and proposed legislation in states such as California focused on redefining the duties of corporate directors. Others are propelled by international debates surrounding the rights and obligations of corporations as expressed in the UN Norms on the Responsibilities of Transnational Corporations. From the business side, the initiative includes change activists within large companies, and visionaries who head medium and small companies. The commonality across all participants is a belief in the need to rethink corporate purpose, rights and obligations, and a perception of a window of opportunity to do so.

For a glimpse of the direction of the initiative, consider the six Principles of Corporate Design the group recently developed after more than a year of dialogue and debate. The goal was to capture in few words, the essence of a corporate purpose and related design that will inspire and guide corporations, government and civil society in their governance, law-making, and advocacy. In short, the Principles provide a beacon and a benchmark of what constitutes enlightened corporations in the coming decades.

1. *The purpose of the corporation is to harness private interests in service to the public interest.*

This principle positions corporations as subordinate to broader societal interests while recognizing the unique attributes of the corporation in delivering long-term wealth. "Harness," meaning tap and channel the ingenuity and resources, is a critical word.

2. *Corporations shall accrue fair returns for shareholders, but not at the expense of the legitimate interests of other stakeholders.*

This principle respects the entitlement of shareholders, but introduces constraints on such entitlements by virtue of "fair" returns and disallowance of conduct that sacrifices the interests of non-shareholders.

3. *Corporations shall operate sustainably, meeting the needs of the present generation without compromising the ability of future generations to meet their needs.*

This principle introduces inter-generational responsibilities of corporations with regard to their products and services, and confronts short-termism as contradictory to such conduct.

> *4. Corporations shall distribute their wealth equitably among those who contribute to its creation.*

This principle speaks to the shared and inseparable contributions of multiple actors to corporate wealth creation, and the imperative of distributing such wealth commensurate with such contributions.

> *5. Corporations shall be governed in a manner that is participatory, transparent, ethical, and accountable.*

This principle describes key attributes of corporate governance that are deemed essential to effective adherence to the preceding three principles.

> *6. Corporations shall not infringe on the right of natural persons to govern themselves, nor infringe on other universal human rights.*

This principle acknowledges the need to assign rights to corporations, but asserts that such rights shall in no form undermine, dilute or supercede the rights of natural persons. It strives to avoid the dichotomous nature of the corporate personhood debates while recognizing the sovereignty of people.

These Principles reflect the best collective thinking to date of our diverse group. While early feedback is promising, little more than a month has passed since their release, allowing insufficient time to assess receptivity to these principles. Like any effort with high aspirations, they will need explication, interpretation and, as importantly, time to gestate in the public domain. Corporation 2020 participants are progressive pragmatists, recognizing that no principles are perfect, and that the work required to attract a broad base constituency has just begun. But animated by a shared sense of opportunity, they are confident that the principles and design work that will follow will make a major contribution to visioning and charting the corporate future.

## Reflections

History is replete with social movements that emerge because of a shared grievance, a pressing need, and a capacity to see a different future. Such significant movements include American independence, the formation of nation states, and struggles against colonialism and apartheid. Other movements speak to the condition of specific sectors of society—the labor movement, the women's rights movement, and environmental movements. Still others are embodied in new institutions such as the idea of globalism manifested in the creation of the United Nations and the Bretton Woods institutions.

Corporate purpose, it may be argued, falls into last category because of its immense success as the foremost engine of wealth creation. In a world where its influence on the lives of people and the environment has ascended to unparalled heights, it is imperative that society collectively—including corporations themselves—ask what its core purpose is and what forms are necessary to live up to that purpose.

Some view the financial success of corporations as a justification to continue along the pathway of incremental change that has characterized the last century. For others, continuing this century-old strategy of containment and control of corporations by fine-tuning laws and regulation without attention to purpose and form is a dereliction of duty. Our hope is that this workshop will shed light on these divergent perspectives, and help point the way forward toward consensus and engagement in addressing one of the most challenging contemporary global issues—the purpose of the corporation.