AN HONORABLE HARVEST: IT IS TIME FOR UNIVERSAL OWNERS TO TAKE RESPONSIBILITY FOR THEIR PORTFOLIOS[1]

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INTRODUCTION: CORPORATE SUSTAINABILITY EFFORTS ARE FAILING

There is now an established industry dedicated to making business more responsible for its impacts on the environment and society. An alphabet soup of organizations promotes "sustainability," "corporate social responsibility" and "ESG (environmental, social and governance) integration." To date, the efforts have been insufficient to the task, as illustrated by our failure to address the climate and water crises, growing political instability and continuing shameful abuses of human rights in supply chains. (This is by no means a criticism of sustainability efforts—things could be much worse without them; it is instead a call to find a path to success for this vital movement.)

This essay argues that current efforts are failing because they require individual companies to make difficult decisions about complex social and environmental issues. However, companies are a poor locus for these decisions because they are in competition with one another to provide a return on equity capital. Even without the pressure of competition, the calculation of optimal returns on equity is incommensurable with the calculation of what businesses must do to maintain a healthy environment and society: there is no rational way for a corporate director to compare a ton of carbon and a penny per share of profit. Businesses respond to this combination of competitive pressure and

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[1] This paper has been prepared for A NEW DEAL FOR THIS NEW CENTURY, a conference to be held on October 3-4, 2019. The concept of an honorable harvest was learned from the book *Braiding Sweetgrass* by Robin Wall Kimmerer. The direction of this paper grew out of discussions for a separate paper being prepared for the an upcoming special issue of *Oxford Review of Economic Policy* on corporate ownership, and I am indebted to Colin Mayer, who is leading that project, and Cameron Hepburn, the discussant for that work, both of whose early insightful comments sparked the idea for a separate paper. I am also grateful to Michelle Meagher and Michael Dorff, who also read that paper and helped provide needed direction.

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incommensurability by only implementing those sustainability measures that are compatible with optimizing returns on equity, rather than those necessary to actually solve the sustainability problem.

In an economy based on market competition, we cannot rely on *individual* businesses to self-impose basic sustainability rules that take priority over profit. By their nature, these critical sustainability boundaries must be implemented *collectively* in order to be effective. While law and regulation would be the traditional avenues for addressing the broad societal concerns that comprise sustainability, governments themselves suffer from collective action issues in a global economy where jurisdictions compete for jobs and revenue.

The ongoing failure of either business or government to systematically address these issues has created a crisis: business practices are eroding the environmental and social structures that undergird our civilization. If we cannot devise a method for implementing difficult decisions about carbon, inequality and other systemic issues, we will continue to just tinker around the edges of concerns that threaten human thriving, rearranging deck chairs as our global economy sinks.

This essay argues that at this historical moment, the global investor community is the appropriate locus for the collective decision-making necessary for a sustainable economy. The power exerted by institutional investors through allocation and stewardship of equity capital can be used to insist on more sustainable business practices. Because they are diversified across thousands of companies, these investors can bypass the competitive bottleneck for margin and capital that holds sustainability back at the company level.

I urge asset owners to consider these arguments, and to act to begin establishing sustainability parameters for all businesses, as our window of opportunity is rapidly closing.

WHAT SHAREHOLDERS WANT: COMMON STOCK BEARS RISK AND MAINTAINS CONTROL

Business is risky. That risk is first borne by common equity. Before a company can pay dividends or payments to its shareholders, it is supposed to pay its creditors, including workers, lenders and suppliers, and even tort creditors who have sued or could sue the company for wrongdoing. When a company goes bankrupt, it is there is often nothing left for shareholders.

But risk has an upside as well as a downside. After all the creditors are taken care of everything that is left goes to the shareholders. It is the shareholders who benefit the most when a company does well. Indeed, when you hear about workers getting rich (like the employees of a Microsoft, Apple or Facebook), it is usually because they were given shares or options to buy shares, so that they shared in the upside risk as shareholders.

The major businesses that influence the economy around the world require large amounts of this risk capital to buy equipment, pay employees and provide financial stability. Lenders, customers, suppliers and other third parties will be hesitant to commit to an entity that does not have a significant cushion of capital to bear the risk of business reversals. This is true for manufacturers that need to buy equipment, software and pharmaceutical companies that need to finance research and development and utilities that must build energy plants and erect huge distribution systems.

Significant amounts of equity finance thus stand behind these juggernauts of the capitalist economy; a controlling share of the money providing that financing comes from institutional investors, including defined benefit pension plans, insurers, sovereign wealth funds, endowments, foundations and pooled investment vehicles like mutual funds. These funds invest in the $70 trillion global public equity markets (listed companies) and the $10 trillion global market of private equity and venture capital partnerships. The ultimate owners of these large pools of investments are, for the most part, ordinary human beings—workers, citizens, students, insured and other beneficiaries of the funds.

The residual risk bearing common shareholders (or their agents or appointees) have the great authority over companies through decisions of where to invest and how to vote shares once an investment is made. For example, a defined benefit pension plan is run by trustees on behalf of workers, and those trustees invest a portion of the assets into common shares, and, in general, those common shares entitle the holders to elect directors who manage or oversee the management of the corporation. Thus, although the workers do not make direct decisions about the business, the trustees of their retirement plan, working as fiduciaries on their behalf, have the ability to change the direction of a corporation by electing directors.

BUSINESSES ARE DESIGNED TO PURSUE PROFITS, WHICH CAN BE GOOD

This system of control and residual risk bearing biases managers in favor of common stock—corporate executives seek to increase the residual value that is available for shareholders. Corporate law and finance scholars debate the nature of that bias, and the degree to which it reflects a legal mandate that controls the obligations of corporate directors and fund trustees. This debate, however, is largely around the edges. The $80 trillion of risk capital circulating through our global capitalist system exerts irresistible influence over business though its allocation and stewardship, and that influence is largely directed towards creating value for the ultimate owners of the capital, who are the human beneficiaries of the institutions that dominate the equities markets.

This does not mean that corporate directors only consider the interests of shareholders. Business is complex, and successful operation requires balancing the interests of multiple constituencies, including workers, customers and communities. Wise managers may sacrifice short-term returns in order to pursue innovation, develop a loyal workforce or head off regulation. Thus, a manufacturer might decide to spend money on research and development, on paying workers more than the labor market would require and on reducing its carbon emissions. All of these actions might decrease the return to shareholders initially, but pay off in the long run, because the company may end up with innovative products being manufactured and sold by a loyal and motivated workforce to consumers proud to support a company that protects the environment. These sorts of trade-offs between the short and long term are the stuff of business.

But these difficult decisions are made in a competitive environment. Companies are designed to create profits, even if there are difficult decisions to be made about whether to forgo today's gains for more profits tomorrow. That is why managers constantly seek to justify long-term investments in terms of shareholder value—they do not tell shareholders they are paying employees more than necessary because they are altruistic—instead they argue that a higher-than-market pay scale is an "efficient wage" that motivates workers and keeps them from looking for other work; R&D is justified to shareholders not by the good it will create in the world, but by the future profits that new products will bring. And carbon emission reduction is justified to the capital markets by the need to get ahead of the curve of coming regulation—or even to forestall such regulation—but never simply because we need to limit the concentration of carbon in the atmosphere to preserve prospects for our descendants.

Anyone who has spent time in a large business understands that there is a constant pressure to lower costs and increase margins. And anyone who has taken Econ 101 understands that this pressure is a key factor in increasing productivity, making us materially better off year after year. The competition to create profits and thus value for shareholders, especially over the long term, can lead to innovations and efficiencies that allow our economy to do more with less, allowing billions of human beings around the world to live long and comfortable middle class lives, and has the potential to lift millions more out of poverty every year. But the profit motive has a dark side, as well.

PROFITS WITHOUT HONOR: EXTERNALITIES AND EXPLOITATION

While shareholder return can derive from real value creation, it can also come from depleting resources that benefit others, or from exploiting the powerless. An obvious example is slave labor: forcing human beings to work for bare subsistence may prove profitable, by allowing a company to make more profit. Sadly, this is not an unrealistic example—supply chains extend around the globe, and some industries in some jurisdictions have working conditions that are not meaningfully different from slavery. It is quite possible that a child as young as seven helped mine the cobalt ore used to make your smart phone battery, and that that child has since died from neglect.

Maybe this conduct is good for a company's share value, or perhaps it will decrease that value in the long run if the reputation of the company suffers, or if the failure to address this human rights disaster leads to costly regulation. But the overarching problem for sustainability is that the decisions on this issue are being made by corporate managers seeking profit, so that the financial question factors into every calculation of where to buy raw materials and how much money to spend on supply chain auditing.

The same analysis applies for environmental issues. A company's current bottom line may be hurt if it acts to reduce the amount of atmospheric carbon concentration it is responsible for. Some of its profit may be derived from using up our very limited capacity to emit carbon before significantly reducing the quality of life for current and future generations. As with modern slavery, there certainly may be carbon questions where the long-term interests of society and the long-term interests of a company's shareholders coincide; perhaps a company could decrease its carbon emissions by 10% through a combination of efficiency, change in fuel and circular business models. The board might calculate that the upfront cost for reduction will be paid for by lower energy bills down the road, reputational benefit and employee morale building. On the other hand, the board might determine that an additional 10% reduction would be more costly and deliver less incremental benefit to shareholders.

The important point to remember from these illustrations is that the current sustainability movement tries to improve internal company decisions as to whether to preserve or deplete an important public good, and the individuals who run the company must factor in questions of profit and loss with each decision they make. They cannot afford to ignore that factor, or to make honorable sacrifices that competitors choose not to make.

GOVERNMENT'S JOB?

At this point some readers may think that we solve this decision-making problem with laws and regulations. After all, don't we have laws to require certain wage and benefit rules? Don't we have rules about emissions and regulators who protect consumers from companies looking to make a buck at others' expense?

While such regulation is certainly an important function of government, the fact is that in a complex and globally interdependent economy, it is quite difficult for government to completely fulfill the role of protector of the environment and society. With global markets and jurisdictions competing for investment and jobs, companies can arbitrage regulation by moving production to regions with weak regulation. Think of those cobalt batteries in smartphones, purchased in the United States, made in China with minerals mined in the Democratic Republic of Congo and spinning out royalties through a tax haven.

Moreover, companies have become very powerful, and are able to influence regulation in order to grow profits even if they come at the cost of common goods like a clean environment or stable markets. Thus, we see large contributions made to political campaigns by profit-seeking corporations in order to influence legislation that may interfere with those profits. Once again, companies are designed to optimize profits, and influencing legislation is one way to do that.

GRAZING THE COMMONS

The dynamic I have been describing is leading to tragic and alarming consequences. Despite our understanding of the terrible risks of climate change, we are increasing, not decreasing, carbon emissions. Industry remains willing to buy minerals hand mined by children. And society's growing material wealth becomes more concentrated in the hands of the few while a billion human beings live on a dollar a day. Billions of other sentient beings live and die in misery without any consideration whatsoever.

These sad deeds are not the results of evil people for the most part. They result from historical contingencies, including the fact that, in a span of a few hundred years, the human condition has been drastically changed by a combination of capitalism, fossil fuel, technology and other factors. We have gone from a population of hundreds of millions subsisting on a generally (if not entirely) circular and isolated agricultural basis to seven and a half billion humans in a complex, interdependent global economy producing ever increasing amounts of industrial and digital goods and services. In the growth stage, the material benefits from honorable profits from value creation outweighed the dishonorable profits that came from exploitation.

But the resulting market economy provides no check on profits made through the destruction of significant portions of limited planetary and societal resources, creating a global tragedy of the commons. Some of the very factors that fueled growth and increased material well-being—free markets and capitalism—are now rewarding companies that deplete social and environmental resources that contribute to our common good, or violate principles that underlay our common humanity, as long provide competitive shareholder returns. Competition got us here, but we need another plan to maintain what we have.

It is not simply a matter of breaking old habits, however. The corporate behavior that is leading to collective large-scale disaster is perfectly rational from an individual company perspective. Because each company makes up a small part of the whole system, no single company is responsible for systemic outcomes. If a company can improve its long-term profitability by generating a little more carbon, it will not have a cognizable effect on the climate, but it can affect its own profits significantly. It is a classic example of the prisoner's dilemma: whether or not the world gets its act together, any one company will always be better off exceeding its fair share of our collective resource budget. Thus, like the villagers who are each rationally incentivized to overgraze the common meadow, leading to failure for the entire village, rational companies make decisions not to audit supply chains or use renewable energy because they have no rational reason to do otherwise. How can we instill the value of an honorable harvest?

CREATING A BOUNDARIES

But if the system that is brutalizing workers and threatening humanity's future is the system that brought medicine, stable food supplies, education and longevity to billions in the middle class, have we arrived at a Morton's Fork, with no good option? Do we need to choose between the poverty of the pre-industrial age and apocalyptic fears for tomorrow?

No.

The problem is not industry, technology or global trade. It isn't human nature or the nature of capitalism. The problem is that we have not found a way to take the destructive and exploitive choices off the table. Capitalism is very good at finding solutions to solve problems of production and distribution because markets are very good at bringing resources, financial capital and labor together to find those solutions. The problem is not with the tools we use, but with the fact that we fail to discriminate between profits that come from solving problems and profits that come from endangering our future or exploiting others.

We need to discriminate between the honorable and the dishonorable. If all businesses were required to limit their resource budgets to their fair share of the commons, they would compete to find the most efficient way to do so. If they were required to have a demonstrable zero-tolerance policy for modern slavery in their supply chain, there would be competition to provide for such verification in the most efficient way possible. But, as noted above, government seems to be failing at the job of providing those boundaries. Is there an alternative?

There is.

THE POWER OF UNIVERSAL OWNERS

Institutional owners collectively control a huge portion of portion of private enterprise around the world, either directly through investment in public companies and private equity, or indirectly through the supply chains that depend upon those companies. Modern investing techniques lead these investors to diversify their holdings across companies, asset classes and geographies; as a result, these investors—often called “universal owners”—are affected by the performance of equity as a class much more than by the relative performance of individual companies. As sustainability decision-makers, they should be immune to the prisoner’s dilemma created by the competition among companies.

These universal owners can use their influence over capital to impose uniform rules that preserve social and environmental capital, including rules about resource use, worker treatment and human rights. They have the tools: institutional shareholders have used their power as voting shareholders to change the way that corporations are governed in the United States—twenty years ago, large companies listed in the United States generally had staggered boards, plurality voting and other structures that shareholders viewed as unfair. Institutional shareholders have used their influence—backed by the implicit or explicit threat to remove directors—in order to reverse this scenario. Indeed, now that they have been successful doing so, they have even more power to insist the companies in their portfolios act responsibly.

Many of these universal owners hold shares through giant asset managers like BlackRock, Vanguard and State Street, who have trillions of dollars in assets under management, making the organization and disciplined voting of these interests that much more possible. Even outside the public company sphere, it is these same institutions that invest in and negotiate with private equity and venture capital partnerships, giving them access to these companies as well. While they do not have direct access to family-owned companies, those companies are reachable through supply chains, as well as through regulation and newly established norms that universal owner action can instigate.

To reiterate, current efforts to make companies more responsible are haunted by the tragedy of the commons. These efforts continue to focus on decisions made by boards in the crucible of competition. That is why the current movement is insufficient—these companies will always be trying to figure out how to win the battle for increased margin at the same time they are deciding whether to throw another log on the global warming fire. Those decisions just aren't commensurable.

In contrast, if universal owners impose an environmental mandate, there will be no opportunity for directors to decide whether to engage—they will follow the mandate or lose their seats. The job of directors and managers will be to compete within the sustainably boundaries created by universal owner action.

BUT WON'T UNIVERSAL OWNERS BE JUST AS BAD AS INDIVIDUAL COMPANIES ON THESE ISSUES?

Even if universal owners *can* impose rules for environmental and social sustainability, some will argue they have no motivation to do so. Instead, it will be argued that the trustees for pension funds or other asset owners are bound to make money for their beneficiaries, rather than acting as guardians of the commons or protectors of the exploited—honor just does not enter into their calculations.

In fact, however, the medium of universal ownership can change the message from harmful competition to constructive collective action: The interests of these owners run with companies collectively, not individually. In the tragedy of the commons, the individualistic pursuit of advantage ends up harming all the shepherds, because eventually the common resource is completely depleted. It is the same with a resource like sustainable carbon concentration: the climate crisis will devastate the economy. The fact is, companies as a class will do better if they can all restrain themselves; they just have no incentive to do so individually. In contrast, universal owners, who hold diversified investments across the economy, are motivated to insist that all companies sacrifice any individual benefit they might get from overgrazing, because the climate crisis threatens the long-term health of the economy. This is because many costs that are *externalized* by individual companies are essentially borne by other companies; because universal owners are diversified, they *internalize* these same costs.

It may still be objected that many of the costs that companies externalize are not internalized even by a universal owner portfolio—or at least not to the full extent of the value gained by the externalizing companies. Perhaps this is true—maybe companies are able to make so much money from raiding the commons that their profits will overcome the losses they will experience as rising seas, resource scarcity and growing social instability lower productivity. *But the beneficiaries of these funds and those they care about will suffer as individuals from these crises,* and surely their welfare should be taken into account.

But what about externalities that fall on the poorest—those who do not benefit from pensions or insurance at all? What about children digging cobalt from the ground with their own hands? Surely, they are not in any degree beneficiaries of the funds held by universal owners, and must therefore be disregarded by them and their fiduciaries?

THE HONORABLE OPPORTIUNITY

The need to answer that last question is depressing, but let me try to meet the objection, as well as many of the concerns I have heard about using universal ownership as a mechanism to create a truly sustainable capitalism.

The claim I am making is not that universal shareholders have the incentive, foresight or power necessary to create a perfectly sustainable system of capitalism. *My claim is that universal shareholders do not have the competitive burden that companies and their managers do, and that this difference can change the game.* Companies cannot be depended upon to make the full financial sacrifices needed to reduce inequality or freshwater depletion at the same time that they are compelled to compete with other companies for profits. That is why current sustainability efforts only target “win-win” opportunities that allow companies to adopt sustainable practices that do not reduce financial returns.

Assigning the initial responsibility for sustainability to universal owners eliminates the burden of competition. Universal owners can choose to impose a rule because (1) it avoids commons grazing that hurts the overall economy return and thus their own returns, (2) it avoids costs that directly affect the welfare of their human beneficiaries or (3) we share a common understanding that some things are wrong (like slavery and child labor). In each case, the solution is more tenable than one that is self-imposed by individual companies, because with universal owner mandates, no single company (or shareholder) will be peculiarly disadvantaged or forced to choose between the right thing and the profitable thing—that decision will already have been made. Profit-oriented decisions will be made within sustainable boundaries, with all companies (and shareholders) relieved of the burden of deciding between profit and sustainability.

WHAT IS YOUR MODEL?

I want to recap by using some economics vocabulary to describe the shift to honorable profit. Market proponents rely on Adam Smith’s “invisible hand”—the concept that by allowing each participant in the market to pursue their own best interests, societal wealth will be maximized. This is the source of Milton Friedman's famous dictum that the social purpose of corporations is to make profits. While often claiming to reject market fundamentalism, today's sustainability movement nevertheless tries to work within a Friedmanesque construct, as can be seen from the constant refrain that a focus on sustainability over the long run will make more money for shareholders, and that all we really need to do is provide information and education to show that the interests of society and profits ultimately converge if we peer far enough into the future.

This strategy is self-defeating. The sustainability movement should instead be loudly making the point that *the actual economic model of the invisible hand does not work that way.* Two hundred years after Adam Smith intuited the idea of the invisible hand, it was formalized as the First Fundamental Theorem of Welfare Economics, which says that a completely free market (with full information and in which traders bear the full costs and benefits of their trades) will lead to a Pareto optimal equilibrium—a situation in which no one can be made better off without making someone else worse off. *In other words, an invisible hand guided by the profit motive—even over the long term--does not account for externalities and does not provide any mechanism for fair distribution.* The Pareto optimal solutions allow those who begin well off to enjoy virtually all the gains of trade and ignore any social or environmental costs that economic activity imposes on third parties.

Thus, it is no surprise that a robust free market has led to lots of wealth on an absolute basis, but also crushing inequality, and dangerous environmental and social costs—it is exactly what the economic model would predict. That is why we must find a mechanism to eliminate market choices that exploit negative externalities and inequality, that is restrict market choices to those that create value and fairly share gains. Universal holders appear to be in the best position to do so, given the current construct of our capital markets.

NOW WHAT?

We know that universal owners frequently meet to discuss sustainability. However, almost all of these discussions involve searches for “win-win” strategies that allow boards to make incremental progress and to be “less bad.” What is painfully obvious is that these well-intentioned efforts are not getting the job done, because there are no boundaries that establish a clear sustainability framework that all companies must work within.

Universal owners must build that framework and should start with the most desperate problems: climate change and inequality. They need to ask themselves a question: what substantive rules (not process or disclosure rules) can actually preserve common resources and promote equality and will be broadly actionable and verifiable? Perhaps it is a plan for carbon neutrality by 2040, a science-based target for a 1.5˚ world based on standardized criteria, or a living wage throughout the value chain. These rules then need to be implemented through engagement throughout the entire portfolio and the relevant supply chains We do not need perfect answer to start, just rules that are directionally correct. Initiating collective action that is approximately right for saving common resources is infinitely better than continuing to rely on individual decisions that balance profit and continued resource depletion.

At the next gathering of universal owners, let’s begin to establish real sustainability boundaries. This will allow us to leverage all the good work done to date on disclosure and board competence as companies begin to compete not just for profits, but for an honorable harvest.