

Contract costs, stakeholder capitalism, and ESG

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Abstract

Observed contract structures are competitive solutions to the problem of maximizing stakeholder welfare when contracting is costly. Winning contract structures typically set fixed payoffs for most stakeholders, with residual risk borne by shareholders, who then get most of the decision rights. With rising interest in environmental, social, and governance (ESG) issues, there is sentiment for replacing the max shareholder wealth decision rule with max shareholder welfare. This view does not recognize that investors view max welfare in terms of their overall consumption-investment portfolios. Since firms are not privy to the total ESG exposures of shareholders, max shareholder wealth is the appropriate decision rule.

KEYWORDS

contract structures, decision rules, stakeholders

JEL CLASSIFICATION

D6; G3; I2

1 | INTRODUCTION

When do market forces push firms toward stakeholder goals? When do market forces push firms toward ESG (environmental, social, and governance) goals? I offer thoughts, first on stakeholder capitalism (Section 2) and then ESG (Section 3).

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2 | STAKEHOLDERS VERSUS SHAREHOLDERS

There is currently much discussion of stakeholder capitalism, the proposition that firms should be run in the interests of all their stakeholders, including workers, and various types of securityholders, and not just shareholders. My theme is that contract structures—the contracts negotiated among a firm's stakeholders—address stakeholder interests.

2.1 | Preliminaries

Contract structures are important in the survival of firms. In a competitive environment, firms have incentives to negotiate contracts that allow them to deliver the products demanded by customers at the lowest cost. This survival competition benefits consumers and I argue that with freely negotiated contracts, it benefits stakeholders.

I focus on internal stakeholders. A firm's suppliers might be included among its stakeholders, but supplier interests are covered by suppliers. A firm's customers might be included among its stakeholders, but in a competitive environment, satisfying customers is a first-order survival consideration for firms. If the firm is a monopsonist or a monopolist, these conclusions might change.

Stakeholder capitalism is not a new concept. It can be viewed as an application of the Coase Theorem. In a world where contracts are costlessly written and enforced, the optimal decision rule for a firm is to maximize the combined wealth of its internal stakeholders. Contracts can then be used to split the wealth among stakeholders.

Note that I take the goal to be max wealth for internal stakeholders rather than max welfare. I eventually offer three arguments against a max welfare rule: (i) Operationalizing the concept of welfare is nontrivial. At a minimum, welfare is multidimensional, and the divergent tastes of stakeholders for different dimensions of welfare likely mean that the max welfare rule is stymied at birth by Arrow's (1950) impossibility theorem. (ii) Even if the max welfare rule gets past Arrow, it is subject to contract costs that typically make it inefficient. (iii) Putting Arrow and contract costs aside, agents (consumers and investors) view welfare from a portfolio perspective. This puts it beyond the purview of individual firms and leads to max wealth rather than max welfare as the appropriate decision rule for a firm.

2.2 | Contract structures: Central argument

When contracts are not costlessly written and enforced, contract costs can explain how max shareholder wealth can displace max stakeholder wealth as a firm's optimal decision rule. In a competitive environment, the survival of firms requires that they cover their costs, including contract costs. If all stakeholders have rights to influence the firm's decisions, they are unlikely to agree about which decisions maximize combined wealth, and they are unlikely to agree about how combined wealth is split among stakeholders. In short, contract costs are likely to be high.

Building on Fama and Jensen (1983a, 1983b), Fama (1990) argues that the common solution to this contract cost problem is a contract structure in which other stakeholders negotiate fixed payoffs (basically, forms of debt) and shareholders bear the residual risk of net cashflows—revenues minus costs. In exchange for fixed payoffs for other stakeholders, shareholders get most

of the rights with respect to decisions that affect net cashflows. I argue in Section 3 that the optimal decision rule is max shareholder wealth.

Fixed payoff contracts for other stakeholders do not mean the promised payoffs are riskless. Fixed payoffs of all types are negotiated to reflect their risks much in the way debt securities (bonds) are priced to reflect the risks of their fixed promised payoffs.

Fixed payoff contracts have details that vary from one group of stakeholders to another. To a large extent, the details centre on controlling the risks of fixed payoffs, how payoff risks are monitored and what happens if promised payoffs are not met. This is a focused range of issues much narrower than those facing shareholders.

Since contracts are not costlessly written and enforced, fixed payoff contracts do not rule out opportunistic behaviour by shareholders. But the possibility of opportunist behaviour is a dimension of default risk that should be reflected in the size of fixed promised payoffs. Thus, contract costs permitting, shareholders have incentives to write contracts that limit their opportunistic behaviour.

Another discipline comes from contract renegotiation. Fixed payoff contracts for labour, suppliers, and so forth, are typically subject to periodic renegotiation. The prospect of renegotiation limits opportunistic behaviour as it is likely to be penalized by higher fixed payoffs in future contracts. Fama (1980) calls this “ex post settling-up.” The basic point is that in a multiperiod setting, reputation becomes a valuable asset (see also Cornell & Shapiro, 2021)

Fama (1990) argues that debt securities (loans, bonds) play an important role in reducing the monitoring costs of the range of fixed payoff contracts negotiated by firms. Debt securities typically stand last in line among the fixed payoff contracts of firms. This gives debtholders a strong incentive to monitor payoff risks. Signals about payoff risks from debtholders lower the monitoring costs of the higher priority fixed payoff contracts of labor, suppliers, and so forth.

In sum, with the freedom to contract, observed contract structures are bottom-up competitive solutions to the problem of maximizing stakeholder welfare in a world where contracts are not costlessly written and enforced. For most firms, the winning contract structure involves fixed promised payoffs for most stakeholders, with residual risk largely borne by shareholders, who as a result have most of the decision rights. There are, however, important differences in the details for different types of organizations (discussed in Fama & Jensen, 1983a, 1983b).

The competition among contract structures to deliver the products demanded by customers at the lowest cost is ongoing. My preference is to let competition produce adaptations, rather than impose top-down changes with catchy names like stakeholder capitalism that are likely rife with unintended consequences.

Stakeholder capitalism is widely discussed. Also, subject to much debate, are somewhat related to environmental, social, and governance (ESG) issues, analyzed next.

3 | ESG ISSUES

The G (governance) in ESG is easy to address. A firm's governance structure is part of its contract structure. In a competitive environment, the firm has incentives to choose a governance structure that contributes to allowing it to deliver products demanded by customers at the lowest cost. How this plays out in the governance structures of different types of firms (corporations, partnerships, nonprofits) is discussed in Fama and Jensen (1983a, 1983b). Constraints on governance choices (e.g., laws that specify the racial or gender or stakeholder

mix of boards of directors) are likely to introduce inefficiencies that, if forced on all producers, are in the end, paid for by consumers.

3.1 | Background considerations

Environmental and social (E&S) issues are more complicated. If E&S goals enter consumer utility functions, they produce incentives for firms to provide products that accommodate these goals. For example, if many consumers prefer the more expensive to produce meat of free-range chickens and cows to the meat of their caged brethren, firms will provide free-range meat without Government incentives. Consumers vote via their purchase decisions, and value-maximizing firms produce the right amount of more expensive free-range meat. In this way, markets provide solutions to some E&S problems.

Asset markets can also help accommodate E&S issues. Most asset-pricing models assume investors only care about the wealth generated by their investments. Fama and French (2007) present a model in which investors also have tastes for assets as consumption goods. In Pastor et al. (2020), the tastes include E&S actions by the firms in investor portfolios. E&S considerations, typically labelled socially responsible investing, are a growing force in the money management industry.

On the asset pricing side, what are the costs and benefits to firms in choosing products and production techniques oriented toward E&S goals? If some investors value the E&S actions of firms, then given net cashflows, E&S virtue by a firm is rewarded via higher share prices, which imply lower expected stock returns and costs of capital. Lower costs of capital help firms in the competition for survival. But adopting E&S goals is also likely to raise production costs, which leans against the benefit of lower costs of capital. Lower costs of capital for E&S virtuous firms also mean that for E&S investors, virtue is its own reward since investors get lower expected returns from the shares of virtuous firms. This is the bottom line from work on this topic, including Fama and French (2007) and Pastor et al. (2020). Needless to say, lower expected returns are not prominent in the marketing materials of ESG money managers.

3.2 | The max shareholder wealth rule

Suppose agents (consumers and investors) have tastes for the ESG actions of firms and they are willing to pay more for the products of ESG virtuous firms and for their securities. In this world, a firm's product is a portfolio of products. The portfolio includes the embedded ESG characteristics of the product and the product itself. Likewise, the firm's securities provide risky financial payoffs and ESG payoffs. On the basis of the prices for products and securities with different ESG characteristics, firms choose where they sit on the ESG spectrum. A firm benefits from the ESG tastes of its customers and investors as these tastes enhance the prices of the firm's products and securities, but the firm's decision rule is max shareholder wealth.

The max shareholder wealth rule is a result, not an assumption. Shareholders are concerned with the wealth payoffs and ESG characteristics of individual securities in terms of how they contribute to the wealth payoffs and ESG characteristics of their portfolios. In a competitive system, a separation theorem holds. Specifically, firms together determine aggregate supplies of wealth payoffs and ESG characteristics of products and securities, but individual firms don't affect the range of ESG exposures and the prices of exposures available to consumers and

investors. Thus, it is optimal for firms to make decisions that max shareholder wealth and let consumer-investors allocate the wealth to achieve optimal consumption and portfolio allocations, including ESG exposures.

This argument is a minor generalization of the reasoning that leads to max shareholder wealth as the decision rule for firms in asset pricing models in which tastes for assets as consumption goods play no role. In these models, investors care about expected payoffs on their portfolios and (in multifactor models) different sources of portfolio risk. They care about individual securities only in terms of how they contribute to the expected payoffs and risks of their portfolios. The production decisions of firms determine aggregate supplies of expected payoffs and risks, but in a competitive equilibrium, aggregate supplies are independent of the production decisions of an individual firm. The portfolio decisions of investors interact with the production decisions of firms to produce prices for expected payoffs and the risks of payoffs, but the production decisions of individual firms have no effect on the expected return-risk tradeoffs available to investors. Thus, firms take the prices for expected payoffs and payoff risks as given and the optimal rule for production decisions is max shareholder wealth, given these prices.

3.3 | Problems with max welfare rules

With the rise of interest in ESG issues, there is sentiment for replacing the max shareholder wealth rule for the decisions of firms with max shareholder welfare. My view is that papers in this vein typically do not recognize that consumer-investors view max welfare from the perspective of their overall consumption-investment portfolios, not security-by-security. As firms are not privy to the total ESG exposures of their shareholders, they are typically in the dark on how to move them towards max welfare (whatever that may mean) and max wealth is the appropriate alternative decision rule.

At the risk of beating a dead horse, the max welfare rule faces other serious problems. Thus, unlike wealth, welfare has multiple dimensions (e.g., E and S and G and multiple dimensions of each) and tastes for different dimensions vary across shareholders. Even if a firm's investors all agree that more is better than less (or vice versa) on different dimensions, they are unlikely to agree on tradeoffs. As a result, maximizing shareholder welfare likely runs into the crippling implications of Arrow's (1950) impossibility theorem.

For example, an E&S virtuous firm may commit to transfer half of the annual profits that would otherwise accrue to shareholders to outside groups that fight for E&S issues. For some investors with positive tastes for E&S actions, 50% may be too much, and for others, it is too little. There is also likely to be disagreement on how the 50% is split among different E and different S actions.

How to resolve this problem? The simple approach is to allow shareholders to use cash payoffs from firms to subsidize E&S virtue as they see fit. But this gives up the tax advantages of donations at the corporate level. Hart and Zingales (2017) argue that since shareholders have the decision rights, a shareholder vote is a possibility. But choosing the specifics of a question is difficult. For example, the question may be whether to produce at a higher cost but with less pollution and there may be a continuum of tradeoffs of costs for benefits. Where should the line be drawn? Moreover, a vote implies winners and losers, and the possibility of unexpected actions that violate the E&S tastes of some investors is likely to make investors less willing to agree to bear the costs of E&S actions by firms.

The max shareholder welfare rule for the decisions of firms also poses contract problems between shareholders and managers. Even with a one-dimension max shareholder wealth rule, manager decisions are subject to uncertain outcomes that make evaluating and compensating managers difficult. In a multidimensional max welfare regime, the contract problem is more complicated. How do we write and enforce a payoff function in which managers are evaluated on wealth along with multiple dimensions of welfare, with the likelihood of randomness in outcomes on all dimensions?

This discussion takes us back full circle to the initial discussion of how contract costs affect the contract structures of firms. The conclusion there is that the costs of writing and enforcing contracts among stakeholders with divergent tastes typically lead to a contract structure in which most stakeholders have fixed payoffs, and residual risk is borne by shareholders, who, as a result, get most decision rights. Pulling the curtains aside, the ESG movement argues that the resulting decision rule should be max shareholder welfare, not max shareholder wealth. But that puts us in the quagmire of accommodating the divergent tastes of shareholders with respect to different dimensions of welfare—a problem that implies high contract costs due to the absence of a meaningful aggregate welfare function and the presence of problems in writing and enforcing the contracts of managers. The max shareholder wealth rule is a one-dimension alternative with lower contract costs than max shareholder welfare.

More important, as argued earlier, a portfolio perspective points to max shareholder wealth as the appropriate decision rule for firms even when consumers and investors have strong tastes for ESG virtue.

3.4 | ESG and externalities

An important impetus for the ESG movement (especially the E, environmental) is the judgment that the actions of firms produce externalities ignored by the max shareholder wealth rule.

For example, suppose there are two ways to produce a product. The cheap way produces pollution that costs the firm nothing. The expensive way controls pollution but at some cost to the firm. If consumers are indifferent to pollution, dirty producers drive out clean producers (Shleifer, 2004). But if some consumers value less pollution or can be convinced by E&S arguments to value less pollution, they can vote for less by paying more for the version of the product produced cleanly at a higher cost. The end result is the mix of clean and dirty products that consumers vote for with their purchases. It seems that a market solution to this ESG problem works—but not necessarily and probably only partially.

Thus, suppose all consumers care about pollution and dirty producers offer the same products as clean producers but at lower prices. Despite their distaste for pollution, some consumers are likely to choose the products of dirty producers because they perceive that their individual choices have little effect on pollution. In short, there is a coordination problem: Everybody would pay more for the products of clean producers if they could be convinced that other consumers would not cheat.

A potential solution is to lobby the Government to control dirty production via regulation. But a Government-imposed solution is not likely to be optimal as there are surely tradeoffs of costs for benefits that change with the amount of pollution and with the evolution of production technology. In the end, imperfect though it may be, E&S activism to shape the tastes of consumers and investors may (and I stress “may”) be more effective than regulation.

The coordination problem discussed above is a type of externality. In general, externalities pose problems that are not amenable to complete solutions from individual firms. For example, putting aside coordination problems (consumer cheating), suppose all consumers value and are willing to pay for less pollution, but all consumers don't buy all products (e.g., most men don't buy lipstick.) In making their pollution decisions, firms weigh benefits to them versus costs to them of producing with less pollution. But this likely means they ignore the benefits of less pollution to consumers who don't buy their products.

It is difficult to find activities free of externalities. For example, candy bars and sugared drinks are potentially toxic for consumers with a tendency towards diabetes. One might argue that personal freedom demands that such consumers eat and drink what they please since they bear the costs and benefits. But they don't bear all the costs, if their healthcare is, in part, paid for by other people through higher premiums for health insurance or socialized healthcare. Smoking and hard drugs are similar examples.

When pressured, the political process may address such externalities, but the solution is likely to be somewhat clumsy. Activism that induces consumers and investors to value E&S-friendly products may be a better (though also imperfect) alternative. On the plus side, activism that affects the behaviour of consumers and investors is a market-oriented approach that may adjust more flexibly to unpredicted outcomes than political solutions.

4 | CONCLUSIONS

My general argument is that market forces address the issues raised by stakeholder capitalism and ESG movements. Market solutions are not perfect, especially in the presence of externalities, but no solutions are likely to be perfect.

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