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HIGHLIGHTS

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Investment in Innovation

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Can the American economy achieve *sustainable prosperity* --a progressive spreading of the benefits of economic growth to more and more people over a prolonged period of time? During the first half of the twentieth century, despite the debacle of the Great Depression, the United States emerged as the world's most powerful industrial nation. In the 1950s and 1960s the United States had not only by far the world's highest per capita income, but also a distribution of income that, until the early 1970s, showed continual improvement. Since then Japan has mounted a dramatic challenge to the economic leadership of the United States and the U.S. income distribution has become increasingly unequal (Maddison 1994; Danziger and Gottschalk 1996). In the 1980s the United States had the widest income gap between rich and poor of all the advanced industrial economies (Atkinson, Rainwater, and Smeeding 1995)

It is not only those at the bottom of the income distribution who are losing out. A distinctive dimension of growing income inequality in the United States has been a drop in the real income of those in the middle of the income distribution--what many have called "the vanishing middle class" (Harrison and Bluestone 1988). Adjusted for inflation, the median income of American employees in the mid 1990s is some 5 percent lower than it was in the late 1970s. Yet since the early 1970s the American economy has grown at an average annual rate of well over 2 percent. Why has such a small proportion of Americans, perhaps only the top 20 or 30 percent of the income distribution, been sharing in this growth?

A major cause of the growing inequality in income distribution has been the disappearance of "good jobs" in the American economy--jobs that provide a high standard of living in terms of earnings, employment stability, and benefits for sickness and old age. The widespread availability of such jobs in the past provided the foundation for sustainable prosperity in the United States; their disappearance has placed sustainable prosperity in considerable jeopardy.

The first place to look for an explanation of the disappearance of jobs is employment trends in the nation's major corporations. A typical top management rationalization for one of these trends, the prevalence and persistence of corporate downsizing, is that changes in competition and technology have rendered a significant portion of existing corporate labor forces redundant in terms of the quantity of people who can generate corporate revenues and the quality of skills needed to do so. From this perspective, downsizing is part and parcel of a strategy for corporate restructuring to enhance the ability of remaining employees to generate the revenues that can sustain their employment. Should the corporation try to maintain existing levels of employment, so the argument goes, the long-term viability of the whole enterprise could be in jeopardy; the obligation of the corporation is to remain competitive, an objective that may well be in conflict with maintaining the prior stock of good jobs.

The realities of international competition and technological change undoubtedly demand organizational restructuring. It is possible, however, that top managers of major U.S. corporations have focused so much on job cutting as the prime mode of cost cutting that they have ignored the allocation of corporate resources to innovative investment strategies. The challenge to high value-added industry in the United States has come from enterprises that have gained competitive advantage not by paying lower wages than American companies pay, but by developing and utilizing broader and deeper skill bases than American companies do.

Sustainable prosperity in the United States now requires that U.S. industrial corporations invest in broader and deeper skill bases than those in which they have invested historically. Investment in such skill bases can generate the higher-quality, lower-cost products that can give U.S. industrial enterprises sustained advantage in international competition. Such investments require strategic decision making by corporate managers who have the ability and incentive to commit financial resources to learning processes that are collective and cumulative. Both the ability and the incentive derive from the integration of the managers into these processes of organizational learning.

However, over the past few decades organizational segmentation and financial liquidity--manifested by higher payout ratios and massive stock repurchases--have come to characterize the U.S. industrial corporation. To reform the system of corporate governance to achieve sustainable prosperity, one must compare the prevailing locus and exercise of strategic control with that which should be put in place. The debate over corporate governance and economic performance centers on three questions (O'Sullivan 1996): (1) Who should control strategic investment decisions in the corporation? (2) What types of investments should they make? (3) How should the returns on these investments be distributed?

Stockholder Control

Thus far in the United States the debate over corporate governance has been dominated by proponents of stockholder control (Jensen 1986, 1989; Scharfstein 1988). They view stockholders as the "principals" in whose interest the corporation should be run. They recognize that stockholders must rely on managers to perform certain functions in the actual running of the corporation, but believe that the task of corporate governance is to ensure that the actions of managers as agents are aligned with the interests of stockholders as principals. In response to the three corporate governance questions, proponents of stockholder control would reply that to achieve superior economic performance, (1) stockholders should have strategic control (2) that permits them (directly or through their managers acting as agents) to allocate their corporate resources to those existing alternative investment opportunities that offer the highest expected rates of return and (3) that enables them to determine the proportion of corporate returns that should be reinvested in the corporation and the proportion that should be distributed to them for reallocation elsewhere in the economy.

The stockholder perspective provides a rationale for Americans who hold corporate stock to live off the accumulations of the past. It does not provide a framework for understanding how the reform of corporate governance can help reestablish the social conditions for innovative enterprise and sustainable prosperity in the future. It is about destruction, not creation.

Managerial Control

One alternative to stockholder control focuses on managerial control (Porter 1992). Unlike proponents of stockholder control, proponents of managerial control recognize that the competitive success of the industrial corporation and the economy depends on investments in innovation that entail specialized in-house knowledge and that require time, and hence financial commitment, to achieve their potential. The importance of investments in innovation creates a central role for corporate managers in determining the allocation of corporate resources and returns.

Proponents of managerial control argue that, with appropriate advice from business academics and management consultants on such matters as "competitive strategy" and "core competence," current managers should be allowed to allocate corporate resources. All current managers need is appropriate advice and "patient capital" that will enable them to see their investments in productive resources through to competitive success. In expressing a need for patient capital, moreover, they recognize (however implicitly) that the value-creating capabilities of productive assets, including human assets, result from a developmental process in which the enterprise must invest.

But, focused as the managerial perspective is on what existing managers think and do rather than on how they are integrated into the productive organizations in which they invest, it provides no analysis of the social foundations of innovation and industrial development. The managerial perspective sees the mind set of strategic managers as determining whether or not an enterprise invests in innovation. It does not see strategic managers as actors in a social environment that includes organizations and institutions.

While ignoring the relation of strategic managers to other participants in the process of industrial innovation, the managerial perspective focuses on their relation to the firm's stockholders. Like the stockholder perspective, it views strategic managers as agents of stockholders, but it recognizes the need for strategic managers to make developmental investments if the enterprise is to achieve sustained competitive advantage. The perspective argues, therefore, for managerial autonomy in setting and implementing investment strategy and looks to large stockholders, such as wealthy individuals and pension funds, to be patient capitalists, that is, to provide managers with the control over financial resources that innovative investment strategies require. Hence the proponents of managerial control disagree with the stockholder control penchant for extracting resources from corporations, mainly because they understand the importance for innovative investment strategies.

In looking to public stockholders to provide financial commitment, however, the proponents of managerial control are looking to a group of people who have never had the ability or incentive to support innovative investment strategies. Public stockholders are, and have always been, financial investors, not industrial capitalists. Even if U.S. institutional investors were inclined to be patient capitalists, the funds they could supply would not generate sustainable prosperity unless there were dramatic transformations in the way in which investments in corporate assets are made. To invest in innovation on a scale that can generate sustainable prosperity, strategic decision makers must invest in broader and deeper skill bases. To have the incentive and ability to make such investments, these strategic decision makers must be integrated into the organizational learning processes for which the broad and deep skill bases form foundations.

Organizational Control versus Stakeholder Control

Once one recognizes the importance of organizational learning to the development and utilization of productive resources, one cannot avoid the fact that, in generating innovation and industrial development, the most important investments that an enterprise makes are in human resources, not physical resources. In line with the conventional concept of property, corporate accounting principles count as expenses both the investments in human resources that take the forms of knowledge and skills and the returns to human resources that take the forms of higher incomes, better benefits, and more stable employment. In corporate law and in accounting practice human capabilities are not treated as corporate assets because people cannot be owned. The conventional concept of property on which this law and practice are based, however, ignores the collective assets and collective returns that are the essential realities of the innovative enterprise. From our perspective--which one might call an "organizational control" perspective--sustainable prosperity, be it in the United States or elsewhere, requires not only that these investments in collective assets be made, but also that those whose knowledge, skills, and learning are central to the development and utilization of these collective assets have the expectation of sharing in the so-called residual, that is, the gains of innovation.

With the increased power of stockholders to extract returns from corporations, a small but growing number of economists and politicians have argued that there are other corporate stakeholders, besides stockholders, who have a claim to corporate returns (see Blair 1995; Reich 1996). The stakeholder perspective accepts that stockholders are principals because they invest in the productive assets of the enterprise. However, it adds that the physical assets in which stockholders allegedly invest are not the only assets that create value in the corporation. Human assets create value as well. Individuals invest in their own human assets; to some extent these human assets are "firm specific" and hence employees make value-creating investments in their firm. In allocating corporate returns, the governance of U.S. corporations should recognize the central importance of these investments in human assets and the employees, along with the stockholders, should be accorded residual claimant status.

The organizational control perspective argues that strategic investment decisions should be made by participants in the corporation who are integrated into the organizational learning processes that can generate products that are higher in quality and lower in cost than those previously produced. Such strategic integration provides the only basis for making investment decisions in the face of the inherent uncertainty of a successful outcome from any decision. Whatever the hierarchical structure of authority and responsibility within the corporation for committing financial resources to innovative investment strategies, those who wield this authority and responsibility must be integrated into the relevant learning collectivities if they are to have the ability and incentive to transform inherent uncertainty into sustained competitive advantage. The stakeholder perspective has no conception of strategic control primarily because it has no theory of the firm other than as a combination of physical and human assets that for some reason (labeled "firm specificity") happen to be gathered together in a particular company.

For the enterprise to remain innovative, investments must be made in organizational learning processes. It is inherent in the innovation process that the breadth and depth of the skills that must be integrated to produce a particular product will change over time as technology develops. The most dramatic changes in the breadth and depth of organizational learning processes occur when business enterprises make productive investments in social environments that favor investments in broader and deeper skill bases. To promote sustainable prosperity, corporate governance must be concerned with investments in social organization that can generate innovation and competitive advantage. In contrast to the organizational control perspective, the stakeholder perspective merely asserts that investment in firm-specific assets can generate "quasi rents" for the investor, but does not specify under what technological, organizational, and competitive conditions such increased returns are generated or why they should be specific to a particular company.

The organizational control perspective argues that, to promote sustainable prosperity, returns must be reinvested in learning collectivities that can generate sustained competitive advantage. The need for financial commitment means that returns under the control of the organization are foundations for ensuring investment in collective and cumulative learning processes. The changing character of organizational learning processes means that cumulative disadvantages will eventually arise if the units of strategic control do not change accordingly. To promote sustainable prosperity, corporate governance must be concerned not only with allocating returns to those participants in the enterprise who are engaged in cumulative learning, but also with ensuring that, in the form of committed finance, control over returns devolves to strategic decision makers who are and remain integrated into the processes of organizational learning.

In contrast, the stakeholder perspective sees returns as attaching to specific human and physical assets and views the claims to these assets as being based on the investments that individual stockholders and employees make. The assumptions that both investment in and returns from productive investments attach to individuals, even when these factors of production are combined in firms, preclude an analysis of the collective character of corporate investment and corporate returns. Hence the stakeholder perspective has no analytical basis for understanding a system of corporate governance that can allocate returns from existing productive investments to new productive investments that are collective.

The problems of corporate governance and industrial development are not resolved by simply advocating that industrial corporations be run for other stakeholders, especially employees, besides stockholders. The danger is that different groups who can lay claim to shares of corporate revenues will, as has increasingly been the case with stockholders, extract corporate revenues whether or not their contributions to the generation of these revenues make these returns possible on a sustainable basis. The result of the creation of a "stakeholder society" might be to increase the propensity for major industrial enterprises and the economy in which they operate to live off the past rather than invest for the future.

If sustainable prosperity is the objective, proposals to reform the corporate governance system must be based on a theory of the innovative enterprise. Without such a theory, stakeholder arguments run the risk of encouraging other groups, besides stockholders, to become claimants to a given, and even diminishing, pool of returns. To avoid such a political and economic stalemate requires a conception of how investments in people working together in organizations can generate the returns in international competition that make sustainable prosperity possible. To make constructive contributions to the corporate governance debate, economists must shed the shackles--both methodological and ideological--of economic theory that does not analyze how an economy develops. They must build their own capabilities for analyzing the processes of industrial innovation, international competition, and the social foundations of sustainable prosperity.

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