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David McLean

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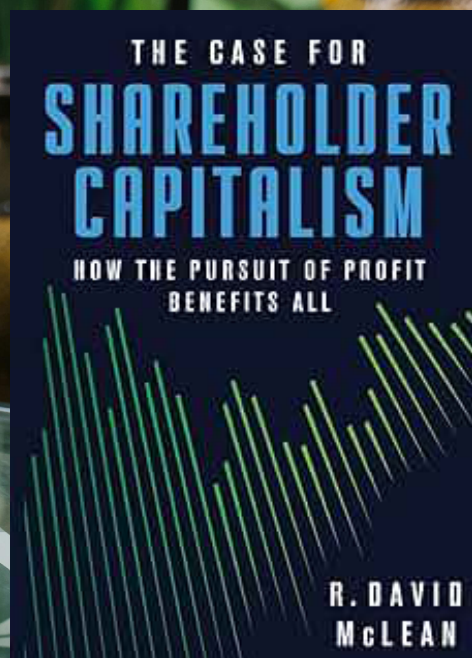
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The Case for Shareholder Capitalism: How the Pursuit of Profit Benefits All

by DAVID MCLEAN

Allow me to begin with a bit of background. Why write a book on this topic? Shareholder capitalism is the underlying theme in most university finance courses. If you take a corporate finance course, we start by telling you that the firm's goal is to maximize shareholder value, which is supposed to be done while obeying all laws and regulations with no fraud or deception.

We then develop several analytical tools that help managers determine if they are achieving that goal. We do not discuss what that means for other stakeholders and the rest of society. If the goal is to maximize shareholder value, what does that mean for everyone else who is not a shareholder? Where does that leave them?

Because we do not talk about that much, a void was created. In my opinion, that void was filled by inaccurate answers that mischaracterized shareholder capitalism. At the same time, enthusiasm has increased for proposed substitutes, like ESG, that encourage firms to pursue various social and

environmental causes. These have problems and do not come as advertised. I wrote this book to address all of that.

The book was written for everyone. It is not technical. You do not need a business or finance background to understand the book. Most of what I say applies to all businesses, and not just corporations. Corporations have shareholders, but a business does not have to be a corporation. It could take on a different legal form, such as a partnership or sole proprietorship. I will first talk about shareholder capitalism and make a couple of the important points that are often misunderstood. Then, I will discuss the idea that firms should pursue other objectives, such as various social and environmental causes.

The big picture for [*The Case for Shareholder Capitalism*](#) is that shareholder capitalism is a good thing because it benefits nonshareholders. It benefits other stakeholders and the rest of society. When firms pursue the goal of maximizing shareholder value, it produces positive

externalities that are good for everyone else. That is why it is a good system.

We can start by recognizing that a business creates wealth for its owners by generating profits. Many think a profit reflects shareholders gaining at the expense of other stakeholders, such as customers, suppliers, and employees. That is not true—a profit results from mutually beneficial trading. Customers only buy a firm's product if it benefits the customer. Employees only sell the firm their labor if it benefits the employee. Suppliers only sell their firms' goods and services if it benefits the supplier. In market and capitalist economies, no one is forced to do anything. Each party only trades if it benefits. Profits reflect the shareholders' or business owners' gains from these trades. We could describe a profit as a leftover that a business owner gets to keep after making the other stakeholders better off, so the shareholders or business owners eat last.

When we say the firm's goal is to create shareholder wealth, it is implicit that the firm must serve its other stakeholders, who are free not to trade with the firm. A firm cannot serve only its shareholders. A firm can only create value for its shareholders if it engages other stakeholders. A salient way to see that is to recognize that most new businesses fail within five years of opening. You cannot start a business and demand profits from people. Other stakeholders must want to trade with the firm and only do that if it benefits them.

Another important issue that gets confused is that shareholder value is a long-term concept. It is not a short-term concept. Some critics of shareholder capitalism claim it encourages short-termism in public firms. Short-termism means skipping valuable investments to have higher short-term profits. Shareholder capitalism does not encourage this in any way. I hope that all students of finance know this.

The ultimate goal of shareholder capitalism is to maximize shareholder value, which is the value of the business minus any debt. As we teach finance students, a business's value is the present value of all its future cash flows, driven by future

profits. An estimate of the stock price would be shareholder value divided by shares outstanding. Short-term profits are typically only a very small part of the value of a business and shareholder value. Long-term profits and growth in profits are far more important.

A way to see this is with the example of IPOs. Over the last 20 years in the US, the majority of IPOs were tech and biotech firms. The majority of those tech and biotech firms had losses. Even though they were losing money and not making profits, some were worth hundreds of millions or even billions of dollars. How can you have a shareholder value worth billions if you lose money? It is because shareholder value is a long-term profit. People think the firm's losses will turn into profits in the future, and those profits will grow. When you take the present value of all that, you can get a big number.

How do corporate managers maximize shareholder value? They do so by maximizing the value of the business, which is largely driven by future profits. They do so by making investments where the future profits exceed the cost. We call those positive net present value or positive NPV investments. To maximize shareholder value, you must play a long game. It is not a short game.

It is very common for firms to make investments that lower current profits but increase shareholder value. Any basic finance class would teach students examples like this. In 2023, Pfizer invested \$10 billion in R&D. That investment made their profits lower by billions of dollars. But I would bet it made its shareholder value and stock price higher because investors recognize that those investments will create profits in the future. The present value of those future profits is probably much greater than the \$10 billion that Pfizer invested.

How do things look at the economic level? What if we have an economy full of firms trying to maximize shareholder value? What does that look like? The overarching problem of any economy is how to best use scarce resources with

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alternative uses. What goods and services should we make and in what quantities? Just as importantly, what goods and services should we not make? Profits, especially profits over the long run, give us the answer.

A profit reflects what consumers are willing to pay for a good or service, less the cost of creating that good or service. A profit means the value of what a firm created is greater than the value of the resources it used. When firms make a profit, the economy grows, and society gets better off. When firms are governed by profit-seeking, society has a de facto rule that only uses resources to create goods and services that are more valuable than the resources used. Profits, I would argue, are perhaps the best way to measure whether a firm creates value for society—or at least one very good way. As we saw with IPOs, it can be okay to have losses in the short run. However, if a firm cannot create profits in the long run, it is making its shareholders poorer and harming the rest of society.

As a thought experiment, imagine if every firm strived for long-run losses instead of profits. Losses mean firms use resources that society places a high value on and create goods and services that society places a low value on. That makes the shareholders poorer, but it also makes everyone else poorer. If enough firms did that for long enough, we would all go back to living in poverty.

Now, I want to switch gears. I want to discuss the idea that firms, instead of just pursuing shareholder value, should pursue various corporate and social responsibility objectives. The first issue with that is, let's pose the question, who gets to decide what is socially responsible? Who gets to decide what are worthy social and environmental causes to pursue? These are subjective questions. There is not an objective answer to these subjective questions. People can and do have different views on what constitutes sound social and environmental policy. After all, that is why we have elections. We do not all agree on these things.

It is important to keep in mind that society does not issue an ESG rating. An ESG rating reflects the ideological views of the institutions and those working at the institutions that issued the ratings. Academic research shows that different ESG ratings from different ESG rating firms can be very different for the same company. That is not surprising because ESG is not an objective metric. It is a subjective metric. People can have different views on what good social and environmental policies are.

Labels, such as socially responsible and sustainable, and ratings like ESG reflect what the labelers like and dislike. They do not reflect society's preferences, and they do not reflect some greater underlying economic reality that everyone's overlooking. I could invent a rating tomorrow, and it would be no less valid than the existing ones.

In practice, the labels and ratings tend to promote causes that progressives favor. I do not argue in the book, and will not now, whether these are good or bad causes. These causes are ideological and highly partisan. If a private corporation or individual wants to pursue an ideological cause, that is fine. In a publicly traded corporation, when corporate managers use the resources to pursue ideological causes, many shareholders will not agree with those causes. Yet, they are forced to contribute to it.

Corporate social responsibility and ESG are sometimes promoted—I often hear this in academia—as a correction for a regulatory failure. What is a regulatory failure? When a business operates, it can create externalities like pollution. We hope governments issue regulations to limit those negative externalities that can harm other people, but governments do not do things perfectly. Regulations do not always work, so the argument is that something like ESG can come in and be a de facto regulation and make up for the regulatory failure of the government.

Where I would push back on that is if something is not regulated, it is probably because most people do not want it to be. Just because you or I think something should be regulated,

and it is not, does not mean there is a regulatory failure. It may mean other people do not think the same way we do.

We could also ask if it is difficult to regulate. Perhaps governments want to regulate something, but it is too hard to do. In the US, our federal code of regulation is over 100 million words. It would take someone over three years to read it. George Mason University created a computer algorithm that reads through the whole federal code and estimates how many rules and restrictions are in it. According to it, the US federal code has over 1 million rules and regulations.

The agency that issued the most rules and restrictions is the Environmental Protection Agency. It has issued over 170,000 rules and restrictions and has been adding, on average, 3,000 new rules and restrictions every year since the EPA came into existence in 1970.

In 2017, *The New York Times* used this George Mason algorithm for an article, which asked how many federal rules and restrictions an apple orchard has to follow. The answer was more than 12,000. States and localities have their own rules and regulations. For example, California's state code of regulation has 400,000 rules and restrictions.

Given all these regulations, why do we need additional ESG rules and restrictions? The answer is that some people want stricter and additional rules that are not in the federal code. They cannot get them democratically, so they try this other channel.

It is important to keep in mind that government regulators ultimately have to answer to elected officials. If citizens do not like how we are regulated, we have some recourse. We can vote for different people. ESG comes from the UN working in concert with various financial firms. We did not elect any of the people who came up with this. We cannot vote them out of office, so we probably do not want them issuing regulations for us.

I will end by addressing a question that probably a lot of you may have been thinking about. How do you know whether a business creates value for society? A simple way to think about it is to think of the average person's economic life. The typical person probably trades with a business for wages. They give their labor; the business gives them a wage. They take those wages to trade with other businesses for their necessities: food, shelter, clothing, computers, travel, etc. Those trades make the individual better off, or they do not continue doing them. Without all this trading—if these businesses disappeared tomorrow—we would all live in poverty. If we look at rich countries, rich countries tend to have lots of businesses and trading. Poor countries have a lack of it.

This mutually beneficial trading between businesses and stakeholders is the social value that a company creates. Shareholder capitalism encourages more business, leading to more opportunities for mutually beneficial trading, which improves our lives. That is why I am an advocate for it.

The Case for Shareholder Capitalism: How the Pursuit of Profit Benefits All is available at most bookstores.

This article is accompanied by a [spotlight](#) from the Accountability in a Sustainable World Conference.

[David McLean](#)

William G. Droms Professor of Finance
McDonough School of Business
Georgetown University

