Markets or shareholders?

There is a fine line between professing free-market capitalism and teaching the subversion of those markets that is crossed in business-school classrooms every day.

On the one hand, the textbook description of free markets implies open competition in markets where information flows freely, where no single player is powerful enough to influence aggregate demand or supply, where any advantage a company gains is soon replicated by competitors. On the other, there is the reality of imperfect markets.

We like to believe in the ideal of free markets because competition, we are convinced, is good for the economy. Competition forces sellers to keep the interests of the buyers at the heart of what they do; competition marginalizes and eliminates inefficient players; and competition for customers and resources spurs innovation – forcing businesses to find better, more efficient ways of doing things. In short, these ideal markets lead to an efficient allocation of the economy's resources, making us all better off in the long term.

If there is one principle that informs business school curricula, it is the belief in the efficiency and inherent goodness of free markets.

But there is another principle that contends for the title, and that is the belief that the goal of a business organization is the maximization of shareholder value. According to this principle, business organizations exist to provide their shareholders with the maximum long term return on their investment.

This is a worthy goal, and a valuable principle because in conjunction with a free market it offers the carrot that ensures the efficient allocation of resources. Businesses that aim to maximize shareholder value in competitive markets will use the economy's resources efficiently.

In a real economy – one that is not your textbook picture-perfect market – the maximization of shareholder value is most efficiently achieved by exploiting market imperfections. Market imperfections are any wrinkles in the market that give one company an advantage over others. And exploiting these, too, is a good thing: the fact that so many businesses have exploited the wrinkle of lower costs in China has raised living standards in both China and among its trading partners. Over time, as the wrinkle is exploited, it gets ironed out, and businesses must find other wrinkles.

But when companies get into the business of creating and maintaining regulatory wrinkles so that they can continue to exploit them, we run into trouble. Firms that push for government protection in the form of trade barriers, longer patent life, or more global application of patents are attempting to keep competitors out. This type of lobbying for protection and favorable regulation undermines markets in many industries in many countries, including telecoms, banking, airlines, energy, infrastructure, pharmaceuticals, etc. Sometimes, the results are comical contradictions: pharmaceutical firms arguing for a lowering of import restrictions in foreign markets but a raising of patent protections, in the same breath.

The result of regulating competition out is that we end up with oligopolies – a small number of companies that realize that it is not in their interest to compete too fiercely on price or, indeed, on any other dimension.

And business schools often end up supporting the erection of regulatory barriers to entry. In other words, at the same time as we profess a reverence for the markets, we're teaching the subversion of freer markets. In a toss-up between advocating more competition for the telecoms sector versus protecting the oligopoly, between shortening the life of patents and enforcing them globally, we find ourselves on the side of the oligopoly. Far from cheering creative destruction, we end up advocating creative obstruction.

The result is a loss of the putative gains of a free market. Sellers have little reason to keep the interest of buyers in mind – they're too busy protecting their sources of advantage (think of your telecoms provider); inefficient players are not marginalized or eliminated (think of General Motors); and innovation is not promoted (when was the last time you saw an airline do something innovative rather than cost-cutting?).

Restoring society's eroding faith in capitalism is not something that will happen overnight. Alleviating popular skepticism of business schools and their graduates may take even longer. But a good place for business schools to start is with some soul searching about where their allegiance resides: with efficient markets in the service of society, or with the creation of market inefficiencies in the service of oligopolies?

(Amusing as it may be to watch, the theater of having MBAs take oaths and participate in ring ceremonies is not going to restore society's faith in business schools).

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