The Failure of Jensen and Meckling
Tim O'Reilly

In 1976, Michael Jensen and William Meckling published a paper in *The Journal of Financial Economics* that marked a change in the character of America as surely as an even more famous paper penned 200 years earlier by Thomas Jefferson. The paper's wonky title, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," belies the role that it played in turning America from a land of opportunity into an unequal society with economic mobility more closely resembling that of the British Empire from which we broke away in 1776.

Jensen and Meckling meant well. They had identified a real problem inherent in the rise of shareholder capitalism: professional managers, who work as agents for the owners of a firm, have incentives to look after themselves rather than the owners. The management might, for instance, lavish perks on themselves that don't directly benefit the business.

The solution that Jensen eventually came up with, and proselytized tirelessly from his perch at Harvard Business School, was that the best way to align the interests of the owners and management is to provide the bulk of management compensation in company stock or stock options. That gives management the primary objective of increasing a company's share price, prioritizing the interests of shareholders over all others.

Before long, the gospel of shareholder value maximization was taught in business schools and enshrined in corporate governance. The idea seemed to work — companies began to root out inefficiencies, and as we emerged from the high inflation and slow growth of the seventies, financial markets began a long boom.

But there were already warning signs of another, even more damaging agency problem. The owners of firms were now incentivized to place the needs of shareholders above the needs of their employees, their communities, even their customers. Not only that, the interests of management were now often aligned with those of a new breed of financial speculators — "investors" who were interested not in providing capital to companies in order to help them grow, find new customers, produce new products, and hire more employees, but who were instead interested in extracting capital from companies.

The 1980s began the years of "corporate raiders" celebrated by Michael Douglas's character, Gordon Gekko, in the 1987 movie *Wall Street*, who so memorably said, "Greed is good." The theory was that by discovering and rooting out bad managers and finding efficiencies in underperforming businesses, these raiders were actually improving the operation of the capitalist system. It is certainly true that in many cases they have played that role. But the 80s were also the years when we began to hollow

out the American economy, shipping factories and jobs overseas and capping wage growth for the jobs that remained, focused on the short-term goal of increasing share price above all else.

We can see the apotheosis of this mentality when a corporate raider like Carl Icahn (now rebranded as a “shareholder activist”) can buy a large block of shares in Apple, the most profitable company in history, and demand that the company disgorge its cash into his pockets rather than using it to lower prices for customers or to raise wages for workers. Apple surely didn’t need Icahn’s $3.6 billion “investment” — it was sitting on hundreds of billions of dollars of its own cash. Yet, in order to satisfy Icahn without repatriating and paying taxes on cash from overseas, Apple borrowed — yes, borrowed — tens of billions of dollars a year, spending over a hundred billion dollars on stock buybacks. Meanwhile, its manufacturing workers at factories in China, outsourced to Foxconn, are driven to suicide by working conditions we would not tolerate in America.

Except we do. Suicide rates in what was once the American heartland have spiked. The disease of cost reduction in pursuit of “shareholder value” has led to the outsourcing even of service jobs, which can’t be sent overseas, to vast contracting companies that exist solely for the purpose of cutting employee wages and benefits. We have come to the point where 57% of Americans can’t come up with even $500 to meet emergency expenses, and less than half of Americans can now expect to do better economically than their parents, down from 92% in 1940.

Dow 23000? Meckling and Jensen. Passenger dragged off a plane? Meckling and Jensen. Opiod epidemic? Meckling and Jensen too.

It’s time to end the idea of shareholder primacy, and replace it with a new scorecard that balances the needs of shareholders with those of society as a whole. The master algorithm that guides our financial system, optimizing for share price above all, must be abandoned. We must break the system of incentives that compels company executives to follow the demands of that algorithm. We must distinguish in our tax code between true investment in people, products, and productive capacity, and speculation on the stock price of companies that don’t need capital. We must commit the great engine of capitalism once again to creating prosperity and opportunity for all.

I come to this idea not as an economist but as a technologist. I’ve watched the development of online systems ruled by algorithmic optimizations. and have explored the way those systems must constantly be managed lest they get out of control like the broomsticks of Walt Disney’s Fantasia, summoned by sorcerer’s apprentice Mickey Mouse to help him fetch water but soon flooding his master’s castle.

Spammers found ways to fool Google's algorithms, trained for relentless pursuit of relevant search and advertising results, into thinking their low-quality content would be just what users were looking for. The algorithms were retrained. And must be retrained again. Search and ad quality is a constant battle for Google, a quiet cyber war.

When Facebook's engineers trained its newsfeed algorithms to show people more content similar to what they and their friends clicked on, liked, and spent time with, they believed that they were building a tool for deeper human connections as well as a great advertising-based business. We have discovered to our sorrow that those same algorithms amplified hyper-partisanship, and that they could be exploited using fake news and ads created by Spammers and foreign powers. Facebook is now struggling to correct its algorithms, to root out fake news and to balance partisanship. We expect them to do it, and we will hold them accountable if they don't.

Yet our response to the idea that America's social and economic distress might be due to the financial market algorithms set in motion by Meckling and Jensen? We are still in the state of denial that Mark Zuckerberg was in when the idea that Facebook could have swung the 2016 US presidential elections was first broached, calling it "crazy." No, it isn't.

Tim O'Reilly is the founder of O'Reilly Media and the author of WTF? What's the Future and Why It's Up to Us, *a book about lessons from the great technology platforms for business and the economy, from which this piece is adapted.*

Why We'll Never Run Out of Jobs
Tim O'Reilly

Whenever I hear that the robots are going to take all the jobs, leaving nothing for humans to do, I want to channel Larry Summers. His biting refutation of the efficient markets hypothesis went like this: "There are idiots. Look around." Well, there is lots of work that needs doing. Look around!

Our infrastructure is crumbling, an aging population needs increasing amounts of care, our systems for delivering healthcare and government services are stuck in the past century and in urgent need of modernization, there are tens of millions of refugees and victims of disaster needing to be lifted up as we lifted up our former enemies after World War II, and there is the looming specter of climate change. Oh, and there are billions of people around the world looking to enjoy the advantages that the increased productivity brought by technology has brought to those of us who already have them. And we have to face the challenge of inequality in our own supposedly advanced societies, where the hope of a better future has faded for so many people, while a small number grow ever richer.

Nick Hanauer, Amazon's first non-family investor and a tireless advocate for a more equitable economy, once said to me, "Prosperity in human societies is best understood as the accumulation of solutions to human problems. We won't run out of work until we run out of problems."

But that's only one of three reasons that we will never run out of jobs. The second is explained by something that Clayton Christensen once called "The Law of Conservation of Attractive Profits." Once one thing becomes commoditized, something else becomes valuable. I observed this in my own technology career, predicting how the rise of open source software and the open protocols of the internet would not lead to the end of the software industry but to the rise of new business empires based on big data and collective intelligence.

This same dynamic is at work in our creative economy writ large. When the mechanical spinning and weaving machines of the industrial revolution put hand spinners and weavers out of work, cloth became cheaper, and we made it valuable again with fashion, and brought that fashion not just to the rich, but to everyone, so that ordinary people have more clothes than the kings and queens of old. Millions of people went to work designing, marketing, selling, and distributing the fruits of that productivity.

So too with food. As calories became a commodity, we made food valuable again by mixing it with ideas. "This isn't just ordinary coffee. It's fair-trade, single-origin coffee. And look, we have six different kinds. You must try them all. These aren't ordinary fruits and vegetables. They are organic, farm-to-table. This bread is gluten-free. Is that North Carolina barbecue or Texas barbecue? KFC or Church's Fried Chicken?"

In the next economy, it's clear to me that caring is also one of those things that is going to become valuable. Hal Varian, Google's chief economist, once noted that "If you want to understand the future, just look at what rich people do today." Rich people once took the European grand tour; now soccer hooligans do it. Dining out was once the province of the wealthy. Now more people eat out than cook at home. Everyone has a cell phone, once a rare privilege.

What do the rich do today? They send their children to schools with well-paid teachers and high teacher-student ratios. They have concierge medicine. They have personal trainers and coaches and therapists. They live in a creative and caring economy that, yes, would put millions to work if only everyone could afford to participate in it.

The question isn't whether there will be work to go around. The fundamental question of our economy today is not how to incentivize productivity, but how to distribute its benefits, so that everyone can enjoy them. Why are the jobs we are creating so poorly paid, and why, as our economy has become more productive, haven't wages risen, working hours been reduced, and benefits made more generous?

We are in the thrall of an economic theory that says that wages and working conditions are entirely subject to inevitable laws of supply and demand, not recognizing the rules and incentives we've created that ruthlessly allocate the benefit of increased productivity to the owners of capital and to consumers in the form of lower prices, but dictate that human workers are a cost to be eliminated. Judged by the hollowing out of modern economies, there is clearly something wrong with that theory.

Technology is eliminating jobs because that is what we are asking it to do. If we want to create a better world, it's time to start asking for something else.