Workers and capitalists, unite!

Forget Marx: Now shareholders, including workers' pension funds, are at war with managerial talent, say **ROGER MARTIN** and **MINHEA MOLDOVEANU**

For much of the 20th century, labour and capital fought vigorously for control of the industrialized economy — in some countries, control of government and society as well. Now a fresh conflict has erupted. While business won a resounding victory over the trade unions last century, it may not be as easy for shareholders to stop the knowledge-worker-led revolution in business.

The rising global outcry over CEO compensation provides a hint of how fierce the battle between capital and talent will become. Most shareholders grumbled indulgently when CEO pay packages in the United States soared by an average of 434 per cent between 1991 and 2000. After all, corporate profits were rising and stock markets were booming through the 1990s. However, in 2001, incensed shareholders were stuck with a 35 per cent decline in corporate profits while CEO salaries hardly fell. Shareholders argue heatedly that companies must slash CEO compensation and end the decade of unapologetic greed.

While CEO compensation has started to take a hit as options expire worthless, there is little to suggest that CEOs will be paid radically less any time soon. The reason is simple. In the knowledge-based economy that we live in, value is the product of knowledge and information. Companies cannot generate profits without the ideas, skills, and talent of knowledge workers, and they have to bet on people — not technologies, not factories, and certainly not capital.

In fact, capital is not as scarce as it used to be, especially in the more developed economies. But there is a shortage of talent, and it's getting more acute in North America. Ever since these knowledge workers realized that demand outstripped supply, they have been wresting more of the profits from shareholders. The latter fight back, but their returns continue to slide. The irony won't be lost on labour, which was in a similar plight when it began its fight against capital.

The history of the 20th century is, to paraphrase Karl Marx, the history of the struggle between capital and labour for the largest share of the profits from industrialization. The stage for this great economic war was set during the industrial revolutions of the 18th and 19th centuries, when numerous new products and technologies were invented. Smokestack plants required large numbers of unskilled workers. The robber barons pocketed the profits from large-scale manufacturing, while labourers lived in near-poverty.

The workers of the world fought back the only way they could: They united. The process of collectivization resulted in the Bolsheviks taking control of Russia in 1917, while in Europe and North America, unions used collective bargaining and industrial actions to demand higher wages and better working conditions.

Despite business's efforts to break them, the unions became a force to reckon with in North America's automotive, mining, steel, and trucking industries. A union member in 1933 earned 25 per cent more on average than an equally skilled counterpart in a non-unionized industry; by 1950, he earned 40-per-cent more.

But after the First World War, business also grew rapidly and organizations became bigger. That growth led to managerial capitalism, which transferred the control of companies to professional managers — a trend that accelerated after the Second World War. As companies financed their growth by issuing equity, shareholdings became widely dispersed and the titans lost their stranglehold on shares and companies.

Corporate America intensified its fight against the unions in the 1970s by shutting down plants in highly unionized cities and moving to regions where workers were less organized. The emergence of low-cost competitors in the Far East and Latin America sounded the death knell for U.S. unions in the steel, automotive, textiles, and mining industries. Corporations also invested in automated machines to reduce their dependence on human workers, and the rise of the computer hardware and software industries, and the growth of largely non-union pharmaceuticals and telecommunication services, further eroded the unions' power.

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But by the 1980s, a fresh conflict was already simmering. For years, shareholders had been shifting the burden of achieving business success to professional managers, the white-collar labour that helped them in the battle against unions. But for most of the century, it was a highly unequal partnership. As union power began to decline, investors used the opportunity to seize a bigger share of the economic benefits rather than share generously with their executive partners. CEOs of large American companies were paid 33 per cent less in 1980 than they were in 1960 for every dollar of earnings they produced for shareholders.

Even as capital celebrated its victory over labour, the first skirmishes with talent started. Some managers and academics chose to move into industries where they would not need financial backing to profit from their intellectual capital. In the 1970s and 1980s, managers built up management consulting firms almost entirely with intellectual capital, just as lawyers and accountants had done. The consulting firms convinced bright professionals to sign up with them because they offered higher starting salaries and signing bonuses than shareholder-owned companies did. Moreover, the firms split all the profits among key employees. By the mid-1980s, the consulting firms had defeated the industrial giants in the battle for talent: More than 50 per cent of the graduating classes of the top business schools were taking jobs at consulting firms.

In industries where shareholders' returns depended on key individuals (human capital) rather than the organization (structural capital), the stars began to demand, and get, more. Before the 1980s, fund managers received a fixed annual fee of less than 3 per cent of the assets they managed. Tired of seeing clients earn huge returns on their advice, top fund managers began demanding 20 per cent of the increase in a portfolio's value every year (above a base return of 5 per cent to 7 per cent), in addition to a fixed annual fee. Clients agreed because fund managers had created hedge, buyout, and venture funds that delivered large returns. By the 1980s, top fund managers had become seriously rich.

A few capitalists saw what was happening but had no idea what to do. Jeffrey Katzenberg, chair of Walt Disney Studios, wrote a now infamous memo in 1991 that was leaked to the media. He asserted that the studios put up all the capital and took all the risks, but movie stars, scriptwriters, and directors — the "talent" — stripped off most of the profits. By 1994, Mr. Katzenberg and Disney had parted company.

Not even arch-capitalist Warren Buffett could make headway in the battle with talent. When he became chairman of the investment bank Salomon, Inc. in 1991, Mr. Buffett slashed the year's bonus pool by $110-million (U.S.) and boosted returns to shareholders. Soon the hotshot traders and investment bankers were leaving Salomon in droves and, without them, the company's fortunes fell.

Tensions between capital and talent have escalated sharply since the 1990s because the nature of the economy has changed. Knowledge assets — the managers themselves — became more valuable to a company than its capital assets. CEOs in particular began to flex their muscles.

Many managers used their increasing advantage during the Internet boom's worldwide wave of entrepreneurship. Software engineers and journalists from the United States to China went into business for the first time. Many gave up comfortable jobs in large corporations to cash in on their ideas — and themselves. They extracted millions of dollars by way of founder stock. Most of the wealth disappeared during the dot-com bust, but it sent an unmistakable message to shareholders: Managers would no longer be entrepreneurs on a wage.

Rather, as the fight over CEO pay showed, managers will aggressively seek a greater share of profits from companies. And they're not the only ones: Hotshot researchers, product developers, and brand builders will all demand a share of the upside they have helped create. The contagion will spread, with fewer managers likely to be content with a monthly salary and an annual bonus. Shareholders may ask, is there no end to it? The answer is no.

Of course, talent enjoys less power than capital does in developing economies, where wealth is scarce. Droves of engineers migrate from India to the United States every year to obtain a better price for their skills. People can take on capital only when there is a mature market for ideas. Talented individuals in the United States have thrived because venture capital firms provide financial backing from a new breed of investor. These investors are risk-friendly, adopt a long-term perspective, and, unlike shareholders, realize that they are investing in people.

As shareholders react to the threat that the talent class poses, they have taken one strategy right out of labor's book: collectivization. North America's biggest shareholders are the pension funds, and they have banded together to fight the demands that managers make. In Canada, 19 pension and investment funds, with $350-billion in assets, formed the Canadian Coalition for Good Governance last year, declaring that it will use its powers to keep executive compensation in corporate Canada at "reasonable levels."

Such shareholder coalitions will lobby governments to pass laws that cap CEO salaries. Which political parties will support them? The largest shareholders are pension funds, which largely invest the savings of the working class — so the left will support capital, especially because there is no love lost between the left and the talent class. The latter might be the modern equivalent of the "people," but its members are the richest segment of society. The right will back them.

Shareholders will continue to co-opt talent through stock-based compensation, believing that owning stock will inhibit managers from asking for greater compensation. It won't. Every manager believes that an increase in his or her compensation will lead, if at all, to a negligible fall in the company's stock price. So, though they may own stock in companies, managers will ask for higher non-stock compensation as well.

Above all, shareholders will want to prevent managers from skimming the profits from the company's patents, brands, know-how, and customer relationships. That effort will pose a peculiar challenge because the shareholders' only allies until now have been CEOs and senior managers — card-carrying members of the same talent class that has declared war on shareholder capitalists.

The continued rise of the knowledge worker will create tensions not just between talent and capital but between talent and labour. Most societies encourage the creation of knowledge but, as talent cashes in on the knowledge it creates, the creation process will become a battlefield. Both capital and labour may ask lawmakers to regulate the returns to talent just as policy-makers regulated the returns to utilities in the 20th century.

In the end, capital, labour, and talent will learn to live together as labour and capital did after the great battles of the past century. The manner in which capital and talent fight this war will decide the nature of the peace.

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