"Colleagues Think I'm Out of My Mind": Nobel Prize-Winning Economist Wants to Bring Values to the Capital Market

Prof. Oliver Hart Wants to Bring Values Like Fairness Back to Contracts, Board Meetings, and Shareholders' Meetings ● He's currently promoting an almost subversive idea for democratizing the capital market and involving shareholders in the day-to-day decision-making of companies ● This week he arrived in Israel to attend the Arison Center's annual ESG conference at Reichman University's Arison School of Business ● We took the opportunity to find out with him how his models work in reality

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In the late 1960s, during the student uprisings, Professor Oliver Hart, later a Nobel Prize winner in economics, completed his bachelor's degree in mathematics. "I realized that I didn't want to be a mathematician, and on the other hand, I didn't want a real job yet. It wasn't fashionable in 1969," he laughs. When he realized that mathematics could be used to study economics, he was fired up.

"I was quite a political person, and I liked to argue with people, but as soon as they brought up arguments from the world of economics, I had nothing to answer them. I got tired of losing the debate and decided that I would study the subject," he tells Globes in an interview.

And you were probably the only socialist in the faculty.

"I didn't stay that way for long. My socialism was based on what I learned at home, on a desire for a just society, and on the notion that people who want money and believe in capitalism are necessarily greedy. But it was a gut feeling and not really a well-founded argument. When you study economics and get to know the ideas of the invisible hand and market equilibrium, you realize that capitalism is also a very efficient mechanism."

But when you examine Hart's body of work, it seems that this gap, between the idea of a just society and capitalism, remains unresolved, and he has dedicated his academic life to trying to bridge it. Even if he didn't intend it, all of Hart's research deals with the various facets of what he identifies as market failure: while money, raw materials, and labor hours are measurable and therefore entered into economic equations, fairness and values have been neglected, even though they have a part in the economy.

"It's not that people aren't interested in things in the second category," Hart says. "They just don't know how to measure them, and then they neglect them in their equations, and over time the perception takes hold that these things don't matter, or at least have no place in economics."

Your colleagues will probably say, "Explain to us what economics is."
"Some think I'm crazy."

Hart wants to bring values back, first into economic equations and thinking, and then into real economic life: into contracts, board meetings, and shareholder meetings. He's currently trying to implement a subversive idea - that the shareholders from the public, each and every one of them (even if the shares are held through funds), would vote democratically on the degree of public responsibility of companies.

Prof. Oliver Hart

Personal: Born in 1948, married, and father of two. Son of a British Jewish family. Both his parents were doctors. His mother was born in Germany and left it in 1933 with the rise of the Nazis. In his Nobel Prize acceptance speech, he said that he was a "rainbow child" - his older brother died shortly after his birth, and his own birth was seen as a correction

Professional: Currently a lecturer in economics at Harvard University. Previously, he was at the University of Essex, Cambridge, the London School of Economics, and MIT. In 2016, he won the Nobel Prize in Economics for his research in the field of imperfect contracts.

Something else: Swims and plays the piano. "I always think that if I practice a little more, I will rise above mediocrity. That's probably not true, but I'll keep trying."

This week, he arrived in Israel as a guest speaker at the annual conference of Reichman University's Center for Social Responsibility (ESG). The center was founded two years ago, and since then, it seems like 20 years have passed since the world of ESG. Even Prof. Niron Hashai, dean of the Arison School of Business, where the center was founded, admitted at the conference that the field has already gone out of fashion since the center was founded, against the backdrop of global upheavals. Still, the heads of the center, Hashai and Prof. Ali Bukspan of the Harry Radziner School of Law at Reichman University, believe that it is more necessary than ever. As an expert on conditions of uncertainty and someone who still believes in human society, Hart was chosen to deliver the opening remarks.

"The question of what is private or public is economic"

Hart, a member of a Jewish-British family of doctors, received the Nobel Prize in 2016 for his approach to solving the problem of imperfect contracts. The basic premise is that no contract can predict in advance all the situations that the parties will need in the future, and as the world becomes more volatile and technological developments faster - this assumption is even more true. And yet we all sign contracts all the time - as employees, as tenants or owners of apartments, as investors or lenders, and even in relationships.

"Classical economics talks about very simple things: you produce a product, and I pay you and get exactly what I asked for, and that ends the contractual relationship. But life is more complex. The longer the contractual relationship, the future enters into the equation, and it is never fully predictable," says Hart.

What do you do when you encounter a problem that is not written in the contract? One of Hart's first works was to define that the most important thing in a contract is not necessarily what it says, but who is entitled to decide in cases where there is no answer on paper.

He drew some economic conclusions from this. For example, he defined that the most unclear parts of an agreement should be kept where you have the most trust in the decisive factor, and even better - at home. This is why companies sometimes buy other companies, but not always.

Using Hart's ideas, it is possible to define mathematically how much it is worth for a company to own a certain function in its operations, and when it is worth purchasing it from another company, in a way that requires a contract. Here is a very British example: Suppose you are a coal miner, and I am a coal marketer who buys it from you. If I need high-quality coal and it is difficult for me to define in advance what that really means, it would be more profitable for me to also own the mine, over its workers. But if every kilo of coal you take out of the mine is equally good for me, ownership is less important, and you can sign a contract.

By the same logic, it is easier for a high-tech company to quantify agreements with a distribution channel or a manufacturing contractor than the relationship with the inventor. Therefore, it is advisable to employ the inventor directly and even make him a partner in the company to balance the interests. This is also important for the inventor himself - he is expected to invest in the company's investments that cannot be measured in money, and it is important to him that he does not have to later fight over the result or the remuneration with parties with whom the relationship is purely contractual.

This theory also explains why many investment or loan agreements include a situation in which, when someone does not meet their goals under the contract, ownership of the company or the asset passes to the investor or lender. There is a limit to the pressure they can exert on the existing owners under a classic contract. At some point, the only answer is to unite interests.

Within the framework of the same idea, Hart also answered the question of whether a government should own a service that it wants to provide to a citizen or whether it can be entrusted to a subcontractor. The answer is that the more quantifiable the service is (for example, paving a road, putting up billboards, removing garbage), the more likely it is that the project can be outsourced. If we want to have values like quality, fairness, and human rights (for example, prisons, educational institutions, or hospitals), then it is better for the government to operate them directly. "When you think about it this way, you realize that the question of what should be private and what should be public is an economic question, not a political one, and there is no single answer to it - always private or always public, but according to the specific case," says Hart.

"Anger and revenge are part of economics"

For these ideas Hart received the Nobel Prize. At what point did the gap between him and mainstream economics begin to form?

"In recent years, I have been thinking about a completely different way to solve the issue of incomplete contracts, together with a Swedish lawyer named David Friedlinger, who has already tried this approach in his own practice. The idea is that even if we don't know what will happen in the future, we can agree on the principles and values that will guide us. You can write things into the contract itself, such as: what each party wants to achieve from the agreement and what is important to them, and regulated mechanisms for communication in case of disagreements. The contract will explicitly state that it is not a zero-sum game, because if it were, we wouldn't have to make the contract in the first place."

That sounds a bit naive. Can you give an example of a case where it worked?

"A hospital chain in Canada employed a group of doctors who were unionized. Over the years, the amount of work required of them increased due to changes in the Canadian health care system, and the doctors asked for a raise in their pay. The contract did indeed state that pay could be increased in the event of additional work, but it did not specify the exact terms. The hospital chain refused, and the labor relationship soured. The doctors began to refuse to admit new patients, claiming that the Hippocratic Oath requires them to provide optimal care for those under their care, but does not obligate them to accept new patients. The chain responded by tightening some of the terms, and all of this led to very bad feelings and bad actions.

"It is not at all uncommon for someone to impose their opinion on the other when they reach a stage in the relationship that the contract did not foresee, and then there is a counter-reaction of anger and even revenge. In fact, it is almost expected. But then the time came for the parties to sign a new agreement. The relationship was bad, but neither party had a really good alternative. It was decided that the new agreement would be signed using the guiding principles. The relationship improved greatly. They met frequently to discuss problems that arose, with good communication.

"Later, an opportunity arose to examine the issue when the End-of-Life Act was enacted in Canada, and doctors were given additional hard work - discussing end-of-life issues with patients. The question was how to compensate them for the additional work. Both sides managed to conduct the discussion according to the guiding principles and reach a solution. Then, during the Corona period, doctors actually had less work because elective procedures were canceled, and they agreed to reduce the payment they received. Could this have happened under the previous agreement? Never. They were afraid that they would never get their salary back."

But is this economics? Is this mediation? Is this simply being nice?

"Even if anger and revenge do not exist in economic equations, they do exist in the economic world. If we invest time and goodwill in establishing the guiding principles and receive economic value in return for both of us, it looks like economics to me. Of course, it works in very specific relationships, where it is very important for us - also economically - to avoid the difficult conflicts.

"To those who say I am naive, I show that first there were the examples of my colleague who works like this, and only then, there was the article. Such agreements exist from the level of small businesses to governments. But really, more lawyers are interested in it than my economist colleagues."

"Shareholders should be the decision makers."

This idea also permeates Hart's newest work on capital market democracy, that is, involving shareholders in companies' decisions.

“Companies make decisions with the sole aim of increasing the economic value of the stock,” he says. “But we think that if you asked shareholders what they really want, directly, they would say that they are interested in other things besides money.”

Hart notes that classical economics says that companies should make money for shareholders, and if they want to do good in the world, they will invest their money however they see fit. According to him, there are several problems with this approach. One of them is that sometimes the damage done by companies can be prevented in advance, but it will take an infinite amount of money to repair. Another problem is that shareholders do not know enough about the companies' actions. And third, the CEO's incentive is usually only related to the share price, and not at all to the interests of the shareholders. This distorts the companies' decisions.

This really connects to the ESG idea.

"True, although contrary to the idea of many 'stakeholders' in a company, that is, the idea that a company should take into account not only its shareholders but also the needs of customers, neighbors, and society as a whole - the idea that I propose remains focused on the shareholders, who really own the company and should be the decision-makers.

"We ask something like, will shareholders always want us to pollute more if it will increase their stock price? Or do they want us to balance things out? I don't know. Let's ask them. Were GM shareholders happy to discover after World War II that their company had supplied equipment to the Nazis right up until the U.S. entered the war, to the point where senior Nazi officials said they couldn't have conquered Poland without GM? Was it worth it to them? I don't know. Let's ask them."

Today, Hart argues, there is so much disconnect and intermediary factors between public shareholders and corporate management that only the quantifiable needs of shareholders can pass through this filter, not the entirety of their needs.

Apparently, in the long run, things converge. Investors will leave a company that doesn't act according to their values, and its stock will fall.

"Not really. In the book I am currently writing, which is due to be published around 2027, my colleague Prof. Luigi Zingales from the University of Chicago and I discuss this question, and it turns out that shareholders change anyway and don't really know and certainly don't take responsibility for what a company has done in retrospect. But if they are asked directly, that's a different story."

This approach is liable to fall into all sorts of behavioral economics biases that stem from the way the question is framed. If we ask, "Should we invest in countries that commit genocide?" the question can have different meanings for different people. We will probably also get different answers if they are anonymous or semiotic.

"People also tend to be apathetic and have low engagement if they are simply bombarded with questionnaires. We are thinking of a different approach: we will select a representative sample of shareholders each time, say 150 people, whose job it will be to get to know the issue at hand in depth and discuss it, a bit like jury duty, but voluntary, or like citizens' assemblies, which are a real-life event in the politics of certain countries. The in-depth discussion reduces the weight of the precise formulation of the question."

At the Reichman event this week, Hart addressed the applicability of this model to Israel. He began by admitting that probably only Nobel laureates can afford it: "The rate of Israelis investing in the capital market is higher than in the US. It's even higher than I thought when I prepared this lecture. I asked Chet Giffetti, but he must have misled me. To this day, he has given me no reason not to trust him, but I will be more careful in the future."

But although the shareholders in Israel are numerous, diverse, and active, there are many companies in the country with a single controlling shareholder, for which the model is apparently not suitable. "However, if the controlling shareholder is, for example, a pension fund, the fund can hold shareholder meetings that will determine in principle what they want the fund to vote on in various cases related to social responsibility."

What objections does your model raise?

"People say to me, 'We already have democracy. Citizens vote for governments, and then governments regulate, and that's where values meet the business world. Regulation is the values,' but I say - the money of the companies is so big that it can overwhelm almost any regulation, so that's not the solution."

Hart notes that, parallel to his work, and without her knowing about it, a Danish pension fund has begun asking shareholders for their social preferences. "So we already have some evidence that it's possible."

The political world seems to be going in the opposite direction from what your work indicates: more cynicism, less social responsibility, more towards money as the main prism through which things are examined.

"The Trump administration has changed the SEC rules to make it harder for shareholders to have their voices heard. I think it's very bad, and it's not based on any logic. I really don't understand what they're doing. But it's probably possible to undo some of these moves at some point, after the midterm elections, or after

Trump. I don't believe that ideas that don't make sense will survive for long. The truth will come out in the end."

And the truth is that people want fairness and compassion?

"I don't know, but I do know that the economic processes as they exist today do not allow people to fully express these values within the economy. I of course believe that they want more compassion and fairness, otherwise I wouldn't bother trying to find out, but the mechanism I'm proposing doesn't dictate what they want, it just requires them to be asked."