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A comment on corporations

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There is a continuum between the abstraction of economics theory and the practice of business. The two, after all, coexist in the same domain. The one seeks to explain phenomena which are consequences of the other. In the past few decades the highly stylized version of the firm that exists in economic theory has deeply influenced the way in which business is practiced. This is despite the detail excluded in theory, and the evident mis-characterization of the main vehicle of business – the corporation. Economics cannot theorize correctly about the firm until it absorbs the reality of the corporate form that dominates business.

Mainstream economics is very good at explaining what might happen with respect to economic transactions in an idealized world. That idealized world is created by expunging all manner of irritants that might make it difficult to model or teach. The entire resultant edifice is the tour de force of abstraction that has dominated economic theorizing for many decades. Unfortunately, it is the irritants, the very things removed in the process of abstraction, that are of most importance and interest to those of us trying to explain the real world. And amongst those the modern corporation stands out as a prime example.

The world of Adam Smith and David Ricardo had few, if any, of the large complex production processes that now dominate the economy. A world of small workshops and small farms it would have been familiar to many generations stretching back before their time. Agriculture was the primary activity, and the cycles of harvests provided the most apt metaphors used by writers of that age. The Physiocrats of France provide the iconic example of this pre-industrial thought process that Smith and Ricardo sought to amend to take into account the changes they observed around them.

Later, as economics responded to the challenge of the Marxist critique of early industrialization, it retained its agricultural analytical origins and ignored the increasingly complex production activity housed in the emergent industries of the mid 1800s. Instead it sought to project a more scientific image in the manner of the hard sciences each of which was producing astounding new ideas and creating an aura of inevitable advance and technical discipline. In economics this scientific turn took the form of what is now called the marginal revolution and the steady adoption of a more formal methodology.

Whilst it easy to explain this evolution of economic thought as both an ideological and formalist project it is always surprising to recall how many major economic phenomena were left out of the discipline’s progress. The organization of business, except for the primitive description given to its engagement with so-called markets, is largely ignored and has been set aside as the proper domain of organizational or business theory to be taught outside the core of economics. This is despite the very obvious dominance of large-scale business activity in our modern economies and the inextricable inter-relationships between firm activity and macro-economic results.

This is even true of what is now called micro-economics which is supposedly the more rigorously grounded aspect of the discipline and which forms the foundation upon which theories of the macro economy are supposed to sit. Like much of modern micro, the theorizing of the firm within the mainstream is more axiomatic, logically derived, and ideologically convenient than empirically grounded. That businesses routinely seek to disrupt the marketplace by adopting various strategies, trade combinations, restrictions on the flow of information, and other obvious actions inconsistent with what is taught, leaves economics with little available technique to engage in real-world discussion of the corporation. The standard toolkit of marginal analysis, equilibrium, rationality, and perfections of information stand in stark contrast to the routine uncertainty, limited information, and perpetual change that confronts business management. The attraction of the language of modern micro to our business and investment class is consequently its ideologically convenient cover for wealth accumulation and protection rather than for its explanatory power. Real business, especially the corporation, represents an impossible challenge to economic theory.

It wasn't until the apparent collapse of capitalism in the early decades of the 20th century that the problem of the firm became apparent. Urgent questions were then asked about the stability of the economic system itself and the behemoth businesses that bestrode the landscape. In the context of economics this problem was most clearly articulated by Ronald Coase who asked the simple question, why do firms exist?

In Coase's words:

> "Within a firm these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur coordinator, who directs production. It is clear that these are alternative methods of coordinating production. Yet, having regard to the fact that, if production is regulated by price movements, production could be carried on without any organization at all, well might we ask: Why is there any organization?"[1]

That he even needed to ask such a question demonstrates how remote economic theory had become from the actual activities comprising a real economy. After all, if the naïve model of market supremacy was valid, and if its perfection as an allocative mechanism was supreme, why, Coase asked, do business firms appear to be the preferred option for production by the pragmatic minded business class? What was it that economic theory was missing? His words are telling in another way: note the reference to the "entrepreneur coordinator". There is a need, tracing its origins back to the beginning of the discipline, to attribute business coordination to individuals rather than to systematic organization. The latter smacks too much of central planning. So much so that even Coase, asking the right question, refuses to engage fully with the realities of business.

It was because of this difficulty of engagement that the response within economics to the Coasian challenge was a long time emerging and, when it did, was still somewhat distant from reality. The nature of the firm has engaged a host of economists seeking to respond to Coase's challenge. There are proverbial shelves full of books and papers addressing

[1] R. H Coase, "The Nature of the Firm", *Economica N. S.* 1937, *4*:386-405, reproduced in R.H. Coase, *The Firm, The Market, and the Law*, Chicago, The University of Chicago Press, 1988.

organization. The compendium of papers edited by Oliver Williamson and Sidney Winter[2] is a good example of the genre. Nowhere, though, in the index is the corporation addressed in itself. The vehicle for the firm, its legal construction, somehow eludes analysis.

The most advanced response to Coase came in the form of what is called Transaction Cost Economics [TCE] which argues that there are sufficient costs to transacting in open markets that it is often more efficient to enclose sets of transactions in a contained space outside the market. These enclosed organized spaces are the business firms we observe around us. Indeed, so compelling is the need to enclose transactions within centrally managed firms that it is reasonable to argue that market style organization is the rare exception needing explanation rather than being the rule. This represents a considerable challenge to the modern mainstream position that harks back to pre-industrial times and posits that transacting in "free" markets by arms-length self-interested and rational agents will inevitably produce optimal allocations of resources. The contrast between real business organization and the fantasy of economic theory is nicely captured by Williamson, a primary architect of TCE in the title of his book "Markets and Hierarchies"[3]. Economic theory teaches the supremacy of de-centralized markets. The business world stands firmly in the corner of centralized administration through hierarchy. Our modern CEO's, despite their protestations of support for markets, are more comfortable with activities akin to a politburo than they are to the tumult of the pedagogical marketplace.

Even though TCE represents a well-articulated theory of the firm – e.g. see the summary by Ketokivi and Mahoney[4] – it remains, at heart, an effort to reconcile business with the prior existing requirements of economic theory. A separation still exists between modern economic theory and common business practice which has unfortunate consequences. It implies an inability on the part of mainstream economics to engage in discussion about corporate activity. Modern theory requires economists to view business through the distorting lens of a binary choice: in their world activity takes place either in government or market spheres. Business simply disappears as a category of interest leaving a yawning gap that analysts of real economies are forced to engage by other means.

This disinterest in, and technical inability to comment on, business on the part of mainstream economists leaves economics on the sidelines. Vast swathes of economic activity sit outside the purview of economic theory. Nowhere is this more obvious than in the growing and lively post-crisis discussion of the role of corporations as causes of that crisis and as contributors to the malaise within the middles and working classes of our advanced western economies.

This is not to suggest that mainstream economics hasn't had a great influence on business. It has. The issue is that its influence has been a consequence of the ideological content of mainstream theory rather than of its formal content.

Take, for example, Milton Freidman's infamous 1970 *New York Times* article in which he articulated the right-wing argument that the proper purpose of management in business was to earn profits on behalf of the shareholders who own the firm. In Friedman's telling any other

[2] Oliver E. Williamson and Sidney G. Winter, *The Nature of the Firm. Origins, Evolution, and Development,* Oxford, Oxford University Press, 1991.
[3] Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications,* New York: The Free Press, 1975 .
[4] Mikko Ketokivi and Joseph T. Mahoney, "Transaction Cost Economics as a Theory of the Firm, Management, and Governance", Oxford Research Encyclopedia of Business and Management, Oxford University Press, 2018 [online Oct 2017].

activity, such as those often referred to in what is known as stakeholder theory, are at best a distraction and at worst a loss of wealth to society at large. Friedman, in his familiar patronizing tone, thrashed away at efforts by management to take the interest of non-shareholders into account as representing an incipient form of socialism. Social responsibility, which he invariably put in quote marks in order to highlight his contempt, would extend, in his words, "the scope of the political mechanism to every human activity". How ironic, then, that the Chicago School of thought he was intimately associated with founding, does the opposite: it advocates extending the economic mechanism to every human activity regardless of its relevance.

Here is the final paragraph of that article:

> "But the doctrine of 'social responsibility' taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collective doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book Capitalism and Freedom, I have called it a 'fundamentally subversive doctrine' in a free society, and have said that in such a society, 'there is one and only one social responsibility of business–to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud'." [5]

Freidman's bluster had a very long lasting and pernicious effect on the economy. He helped launch the ideology undergirding the shareholder value version of business theory that takes his notion and raises it to iconic status. For the decades subsequent to his *New York Times* article Freidman's influence has permeated management, business education, business law, and political dialog. It is now taken as axiomatic that managers of corporations must act on behalf of the firm's shareholder owners.

This right-wing framing of the problem of management flows naturally from the need inherent in mainstream economics to reduce all problems to allocations of privately-owned property. Somebody *has* to own a firm in order for the rules of economics to kick in. Who else could it be but the shareholders? That this view, right or wrong, happily coincided with the political need of conservative business advocates made it a powerful and easily absorbed idea. In only a few years after Freidman's article shareholder value theory had swept all before it and had been augmented by all sorts of technical support in the form of Jensen and Mackling's articulation of agency theory[6] in which shareholders are cast as "principals"; Prahalad and Hamel's core competency theory[7] in which managers are urged to rid the corporation of the clutter that might detract from shareholder value; and other importations of mainstream economic into business teaching. Forty odd years later and no one seriously challenges the notion that business ought to be conducted solely on behalf of shareholders.

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[5] Milton Friedman, *"The Social Responsibility of Business is to Increase its Profits*", The *New York Times* Magazine, Sept. 13, 1970.
[6] Michael C. Jensen & William H. Meckling, *Journal of Financial Economics,* October 1976, Vol. 3, No. 4, pp. 305-360.
[7] Prahalad, C. K., & Hamel, G. "The Core Competence of the Corporation", *Harvard Business Review*, Vol. 68, No. 3, 1990, pp. 79-91.

It is not clear, certainly not in the context of his 1970 polemic, whether Friedman even considered the law when asserting the priority of shareholders. It seems more likely he was driven by his own ideological priorities. Yet there was considerable legal discussion on the subject in the early 1930s. In particular there had been a strongly argued dialog between Alfred Berle and Merrick Dodd on the issue initiated by Berle, who argued forcibly along the same lines as Friedman did decades later. Berle's opening paragraph sums the argument up neatly:

> "It is the thesis of this essay that all posers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears."[8]

Dodd published his response a year later, pressing back hard against the notion that shareholders have such primacy. Instead he pointed out that management had been viewed historically as more of a public than a private activity and that, as a consequence, the public impact of a corporation had to be taken into account. In his paper he referred to the comments of the then CEO of General Electric who had asserted that he thought of himself more as a trustee of the institution than as an attorney for the investors.

This dialog was taking place a time of great economic distress, when the government appeared to have failed, and so both writers were searching for a locus of social responsibility. The corporation, and its management appeared to be such a place. But to make it so they needed it to be more than a private entity. It had to have a public responsibility also. Indeed, over the next few decades it was Dodd's perspective that prevailed as was recognized by Berle himself as late as 1954. So, Freidman was simply resurrecting a debate that had been settled twenty years earlier. He re-asserted what had been the losing side: that of shareholder primacy.

Except: there is no legal foundation to the reasoning that management needs to optimize profits for shareholders. As the legal scholar Lynn Stout argues:

> "The notion that corporate law requires directors, executives, and employees to maximize shareholder wealth simply isn't true. There is no solid legal support for the claim that directors and executives in U.S. public corporations have an enforceable legal duty to maximize shareholder wealth. The idea is a fable. And it is a fable that can be traced in large part to the oversized effects of a single outdated and widely misunderstood judicial opinion, the Michigan Supreme Court's 1919 decision in Dodge v. Ford Motor Company."[9]

So, the naïve shareholder value perspective completely both ignores the history of the corporation which is an organizational form that long pre-dated industrialization and misrepresents legal opinion.

More to the point: corporations, far from being products of the free market, are actually franchises of the state. They are sub-contracted jurisdictions.

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[8] Alfred A. Berle, "Corporate Powers as Powers in Trust", *Harvard Law Review*, 44, 1049, (1931).
[9] Lynn Stout, *The Shareholder Value Myth, How Putting Shareholders First Harms Investors, Corporations, and the Public,* San Francisco, Berrett-Koehler, 2012.

To be a corporation is to possess a charter from the state. That charter brings privileges not available to non-corporations. The most notable privilege is that the corporation is recognized as a distinct legal entity separate from any "natural" person who may be associated with it. And because the corporation is brought into existence prior to it being populated or animated by any natural person, it is not owned by any of them. It is unowned. In this sense it is akin to a nation state, the church, most universities, and, at least here in the US, most towns. It would be odd to describe any of those bodies as being owned by the people who animate them. Yet we routinely talk of firms being owned by stockholders. It is this misattribution of ownership that leads most economists astray in their theorizing.

The advantages that the privileges of being a corporation bring have long been recognized. The ancient Romans set up corporations for business purposes for exactly the same reasons we do nowadays: it makes the joint ownership and management of property for short term business purposes much more efficient than alternatives such as the traditional partnership. When a partner leaves a partnership, the remaining partners are obliged to pay out the leaving person's share of the accumulated resources of the partnership. This can often strain the organization to breaking point. In a corporation, anyone withdrawing their financial support simply sells their share to someone else. It is not the responsibility of the corporation to pay out anything. The organization persists, and its shareholders are temporary. This is something that easily eludes mainstream economic theory, but is obviously attractive for any business activity that requires long term investment or complex financing.

Hence the sudden rise of corporations in the business sphere after industrialization. Prior to that, the corporate form was found most often in ecclesiastical or educational settings. Back in Medieval times it was mostly the church and then the universities who operated under a charter. A typical bishopric was chartered. It would be nonsensical to speak of the Bishop owning the bishopric. Each bishop was simply the temporary custodian of what was a long term, if not perpetual, entity.

David Ciepley nicely summarizes this crucial point thus:

> "As is true of a town, a corporate firm's assets are not owned by natural persons, but by an abstract legal entity – the 'artificial person' of the corporation, which assumes the legal position of sole proprietor. This fact should immediately explode the most insidious myth about the business corporation, that it is owned by its stockholders. The whole point of the legal form is to transfer ownership of the business assets to this legal entity, which in principle 'never dies'. This prevents investors from pulling these assets out and liquidating the firm, and it allows economic liabilities generated by the firm to be shifted from natural persons to this entity. Since the legal entity owns the assets of the business corporation, the stockholders obviously do not."[10]

It was this clear separation of the assets of the corporation from the people animating it that was the most advantageous aspect of a charter. The bishopric, university, or town could own, manage, and buy or sell property in its own name. They were all regarded as being legal "persons" for such property-owning purposes. This is the origin of the legal personhood that

[10] David Ciepley, "The Corporate Contradictions of Neoliberalism", *American Affairs* Vol. 1, No. 2, May 2017, pp. 58-71.

has become so controversial in our modern era. And those entities were all granted this privilege, and advantage, because they all were assumed to be producing a public benefit. A benefit that was normally stated in their founding charter as the reason for being given a charter in the first place.

So, the original corporations were a hybrid organizational form. Neither entirely public nor entirely private they were designed to produce public goods using private financing. The quid pro quo being that the private financiers could make a profit as long as the public good was provided as chartered.

It is because of this hybrid design that the theories of the firm found in mainstream economics textbooks miss the point. Or, rather, they start well along the chain of argument and take the corporation as a given. Capitalists adopted the corporate form because of its property-owning advantages over the partnership form. It was a more efficient vehicle for the concentration of the large amounts of cash needed to undertake the risky activities of long-distance trade or industrial production. Yes, the corporate form economizes on transaction costs, but that is a radical understatement: without the corporate form those transaction costs are *permanently* prohibitive to the activity. No sufficient amount of complex contracting – as found in the so-called "nexus of contracts" theory of the firm – is possible in a marketplace.

Not even in an information dense marketplace such we experience on the digital age. And within the walls of the corporation central planning dominates activity.

It is the market that is the anomaly for the organization of production, not the business firm. In particular not the business firm organized as a corporation.

It is also this dependence of the corporation on the state for its legitimacy that has been a source of friction throughout the industrial era and up to today. The tension between the state as contractor and the corporation as sub-contractor has ebbed and flowed with both sides claiming victory at different points in history.

The first big break for the corporation here in the US came as far back as 1819 when the original trustees of Dartmouth – which was then not the college we know it as today – challenged the state's interference in its internal organization. The US Supreme Court ruled in favor of Dartmouth by asserting that the original charter was a contract and thus could not be violated by the state's attempted legislation to upend it. This was the confirmation of corporations having the very property rights that was to be so attractive to later capitalists. Prior to this, and particularly in the UK, industrialization was still taking place in either family run or partnership-run organizations. After the Dartmouth decision the corporate form was dusted off from its Medieval shelf and re-purposed for industry. With its property rights settled and on a firm footing the corporation became the obvious vehicle for business.

Recent controversy is less about these property rights than it is about civil rights. The most contentious examples being the frequent use of the Fourteenth Amendment to extend the rights of business. This is the Constitutional amendment designed to protect former slaves from discrimination, but its overwhelming use in the Supreme Court has been to extend the civil rights of business. It is this much more fractious attribution of "personhood" to corporations that has gained so much attention, especially since the Citizens United case a few years back. By granting corporations freedom of speech, which was surely never on the minds of the Founders writing the Constitution, the Supreme Court carried the notion of civil rights further than ever before and, by extension, twisted the American electoral system even further away from any pretense of democracy.

The Founders were all intimately aware of the corporate form of organization because most of the original colonies were established under corporate charters from the state in England. Indeed, when they were searching for a basis for their new nation, they adopted the chartered corporation as their model, with "we the people" being the sovereign conferring legitimacy on the charter, now called a constitution, and all the usual trappings of corporate existence – bylaws, methods for limiting the charter, etc. simply transferred over. The US is itself a giant corporation in this view.

The Citizen's United case, and the subsequent Holly Lobby case a few years later, the latter extending religious freedoms to corporations, demonstrate the confusion the law has with corporations.

On the one hand the law states that the corporation is its own entity, unowned but with ownership rights separate from those people animating it. This is the property rights tradition of law. On the other hand, at its convenience, the law has looked past that separate entity and attributed the rights of the people within the firm to the firm itself. This is the civil rights tradition of law. All the modern controversy extends from this latter tradition.

The Supreme Court oscillates between these two traditions. Sometimes treating corporations as mere associations of people, in which case it attributes personal rights to the aggregate of those people i.e. the corporation, and other times protecting that same association from the downside of personal property problems stemming from corporate failure i.e. by creating and then extending limited liability rights that natural persons do not have.

So, the tension between the state and its offshoot corporations persists and is magnified by troubling inconsistencies in the attribution of which rights belong with the privileges that corporations are given in their charters.

If corporations want the privileges that give them their transaction cost advantage, then they ought to sacrifice their appetite for civil rights. Or the other way around. Until they do, they will incur the anger and hostility of many more commentators than otherwise.

The aggressive assertion of corporate rights, especially those that allow business to interfere in the legislative process, is detrimental to democracy. Those of us who seek to defend democracy from the oligarchs need to remind ourselves of the franchisee status of corporations. They exist to provide public goods – even if those goods are produced with private means they are public because they flow from the corporate form of organization. Regulating business to this end is entirely legitimate and not at all an interference in the so-called free market. Corporations are sub-contractors of state authority. They have franchised privileges that give them advantages over other types of organizations. The regulatory "cost" of adhering to their chartered course is actually not a burden: it is the price for those advantages. It is the market price for their very legitimacy.

And the contradictions between reality and theory will continue to befuddle economists of all ideological sorts.

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