CHAPTER TWENTY-TWO

*The Corporation in a Democratic Society: In Whose Interest Ought It To and Will It Be Run?**

I

For the questions on which I intend to concentrate here the 'ought' and the 'will' cannot be separated. Twenty-five years is a period long enough for the outcome of the developments to depend on what we will do to shape it. I believe that we have the power to avert some of the unpleasant prospects which current tendencies seem to create. Whether we will succeed in doing so depends on whether we clearly recognize the problem and take appropriate action. All I can attempt here is to indicate the channels into which we ought to try to steer developments.

My thesis will be that if we want effectively to limit the powers of corporations to where they are beneficial, we shall have to confine them much more than we have yet done to one specific goal, that of the profitable use of the capital entrusted to the management by the stockholders. I shall argue that it is precisely the tendency to allow and even to impel the corporations to use their resources for specific ends other than those of a long-run maximization of the return on the capital placed under their control that tends to confer upon them undesirable and socially dangerous powers, and that the fashionable doctrine that their policy should be guided by 'social considerations' is likely to produce most undesirable results.

I should like, however, to emphasize at once that when I contend that

* Reprinted from M. Anshen and G. L. Bach (edts.), *Management and Corporations, 1985*. New York (McGraw-Hill Company), 1960.

the only specific purpose which corporations ought to serve is to secure the highest long-term return on their capital, this does not mean that in the pursuit of this end they ought not to be restrained by general legal *and* moral rules. There is an important distinction to be drawn between specific goals and the framework of rules within which the specific aims are to be pursued. In this respect certain generally accepted rules of decency and perhaps even charitableness should probably be regarded as no less binding on corporations than the strict rules of law. But while these rules limit what corporations may do in the pursuit of their concrete aims, this does not mean that they are entitled to use their resources for particular purposes which have nothing to do with their proper aim.

Power, in the objectionable sense of the word, is the capacity to direct the energy and resources of others to the service of values which those others do not share. The corporation that has the sole task of putting assets to the most profitable use has no power to choose between values: it administers resources in the service of the values of others. It is perhaps only natural that management should desire to be able to pursue values which they think are important and that they need little encouragement from public opinion to indulge in these 'idealistic' aims. But it is just in this that the danger rests of their acquiring real and uncontrollable power. Even the largest aggregation of potential power, the largest accumulation of resources under a single control, is comparatively innocuous so long as those who exercise such power are entitled to use it only for one specific purpose and have no right to use it for other aims, however desirable in themselves. I shall maintain, therefore, that the old-fashioned conception which regards management as the trustee of the stockholders and leaves to the individual stockholder the decision whether any of the proceeds of the activities of the corporation are to be used in the service of higher values is the most important safeguard against the acquisition of arbitrary and politically dangerous powers by corporations.

I need hardly stop to point out how much in recent times policy (especially tax policy), public opinion, and the traditions growing inside the corporations, have tended in the opposite direction, and to what extent most of the agitation for reform is actually directed towards making corporations act more deliberately in 'the public interest'. These demands appear to me to be radically mistaken and their satisfaction more likely to aggravate than to reduce the dangers against which they are directed. There can be little doubt, however, that the conception that corporations ought to pursue public as well as private aims has become so widely accepted even by managements that it seems doubtful whether Adam Smith's comment still applies that the affectation to trade for the public good 'is not very common among merchants, and very few words need be employed in dissuading them from it'.

II

There are four groups on whose behalf it might be claimed that the corporations ought to be run in their interest: management, labour, stockholders, and 'the public' at large. So far as management is concerned we can dismiss it briefly with the observation that, though it is perhaps a danger to be guarded against, nobody would probably seriously contend that it is desirable that corporations should be run primarily in their interest.

The interest of 'labour' demands only a little longer consideration. As soon as it is made clear that it is not a question of the interest of workers in general but of the special interests of the employees of a particular corporation, it is fairly obvious that it would not be in the interest of 'society' or even of labour in general that the corporation should be run mainly for the benefit of any particular closed group of people employed by it. Though it may be in the interest of the corporation to tie its employees as closely to it as possible, the tendencies in this direction give ground for serious concern. It is the increasing dependence on the particular corporation by which a person is employed which gives the corporations increasing power over the employees, a power against which there can be no other safeguard than the facility the individual has of changing his employment.

That corporations tend to develop from an aggregation of material resources directed and operated by a body of men hired for that purpose into what is primarily a group of men held together by common experience and traditions, and even developing something like a distinct personality, is an important and probably inevitable fact. Nor can it be denied that some of the features which make a particular corporation especially efficient do not rest entirely with the management but would be destroyed if its whole operating personnel were at a given moment replaced by new men. The performance and very existence of a corporation is thus often bound up with the preservation of a certain continuity in its personnel, the preservation of at least an inner core of men right down the line who are familiar with its peculiar traditions and concrete tasks. The 'going concern' differs from the material structure

which will still exist after operations have ceased mainly by the mutually adjusted knowledge and habits of those who operate it.

Nevertheless, in a free system (i.e., in a system of free labour) it is necessary in the interest of the efficient use of resources that the corporation be regarded primarily as an aggregate of material assets. It is they and not the men whom the management can at will allocate to different purposes, they which alone are the means which it is the task of corporations to put to the best use, while the individual must in the last resort himself remain free to decide whether the best use of his energies is within the particular corporation or elsewhere.

The fact is that an enterprise cannot be conducted in the interest of some permanent distinct body of workers if it is at the same time to serve the interest of the consumers. The management will take the decisions it ought to take in the interest of society only if its primary concern is the right use of those resources which it entirely controls, on which the risk of their decisions permanently falls, i.e., the equity capital, and if it treats all other resources it buys or hires as items which it must use only so long as it can make better use of them than anybody else. So long as the individual is free to decide whether he wants to serve this or that corporation, the corporation itself must primarily be concerned with the best use of those resources which are permanently associated with it.

The conception that a corporation ought to be run in the interest of the distinct body of people working in it raises all the problems discussed in connection with the syndicalist type of socialism. I have no space here to enter into a full discussion of these and will merely mention that these could be satisfactorily solved only if not merely this body of people became owners of the material resources of the corporation but if they were also able to hire other workers at the going rate of wages. The result would thus in effect be merely a change in the persons owning the enterprise but not an elimination of the class of wage earners. Whether it is really in the interest of the workers that, if they are also to be capitalists, their investment should be in the same concern which gives them employment is at least questionable.

III

There remain then as possible claimants for the position of the dominating interest in whose service the individual corporation ought to be conducted the owners of the equity and the public at large. (I pass over such other possible claimants as the creditors or the local community to whom the arguments discussed in connection with labour apply *a fortiori*.) The traditional reconciliation of those two interests rested on the assumption that the general rules of law can be given such form that an enterprise, by aiming at long-run maximum return, will also serve the public interest best. There are certain familiar difficulties which arise where property rights cannot be readily so delimited that the direct benefits or disadvantages consequent upon the use made of a particular piece of property will fall exclusively on the owner. These special difficulties, which we must try to remedy as far as possible by a gradual improvement of the law, I shall here disregard as not connected with the special problem of corporations.

Apart from these special instances, the general case for free enterprise and the division of labour rests on a recognition of the fact that, so long as each item of resources gets into the control of the enterprise willing to pay the highest price for it, it will, on the whole, also be used where it will make the largest contribution to the aggregate product of society.

This contention is based on the assumption that each firm will in its decisions consider only such results as will affect, directly or indirectly, the value of its assets and that it will not directly concern itself with the question of whether a particular use is 'socially beneficial'. I believe this is both necessary and right under a regime based on the division of labour, and that the aggregation of assets brought together for the specific purpose of putting them to the most productive use is not a proper source for expenditure which is thought to be generally socially desirable. Such expenditure should be defrayed either by the voluntary payment of individuals out of their income or capital or out of funds raised by taxation.

Rather than further argue this case positively I will briefly consider the consequences which would follow if it were to become the accepted view that the managements of corporations are entitled to spend corporation funds on what they regard as socially desirable purposes. The range of such purposes which might come to be regarded as legitimate objects of corporation expenditure is very wide: political, charitable, educational and in fact everything which can be brought under the vague and almost meaningless term 'social'. I propose to consider this question mainly with reference to the use of corporation funds in the support of higher education and research, since in this instance my personal interest is most likely biased in favour of such practices. All that is to be said in this connection applies equally to all the other fields mentioned.

The popular view of these matters is, of course, connected with the idea that corporations are 'rich' and therefore have special duties. What ought to be stressed here is that in the sense in which an individual may be

rich, that is in the sense of having a large disposable income or capital he is free to devote to what seems to him most important, a corporation cannot be rich. In the strict sense the corporation has no more an income of its own than a trustee has in his capacity of trustee. That its management has been entrusted with large resources for a particular purpose does not mean that it is entitled to use it for other purposes. This is, of course, relevant in many other connections than that which concerns me here, especially in connection with taxation.

In fact, the only argument I can discover in favour of allowing corporations to devote their funds to such purposes as higher education and research—not in instances where this is likely to make it a profitable investment for their stockholders, but because this is regarded as a generally desirable purpose—is that in existing circumstances this seems to be the easiest way to raise adequate funds for what many influential people regard as important ends. This, however, seems to me not to be an adequate argument when we consider the consequences that would follow if it were to become generally recognized that managements have such power. If the large aggregations of capital which the corporations represent could, at the discretion of the management, be used for any purpose approved as morally or socially good, if the opinion of the management that a certain end was intellectually or aesthetically, scientifically or artistically desirable, were to justify expenditure by the corporation for such purposes, this would turn corporations from institutions serving the expressed needs of individual men into institutions determining which ends the efforts of individual men should serve. To allow the management to be guided in the use of funds, entrusted to them for the purpose of putting them to the materially most productive use, by what they regard as their social responsibility, would create centres of uncontrollable power never intended by those who provided the capital. It seems to me therefore clearly not desirable that generally higher education or research should be regarded as legitimate purposes of corporation expenditure, because this would not only vest powers over cultural decisions in men selected for capacities in an entirely different field, but would also establish a principle which, if generally applied, would enormously enhance the actual powers of corporations.

This, at least, would be the immediate effect. Yet not the least serious consequence of such a development would be that such powers would not long be left uncontrolled. So long as the management is supposed to serve the interest of the stockholders, it is reasonable to leave the control of its action to the stockholders. But if the management is supposed to serve wider public interests, it becomes merely a logical consequence of this conception that the appointed representatives of the public interest should control the management. The argument against specific interference of government into the conduct of business corporations rests on the assumption that they are constrained to use the resources under their control for a specific purpose. If this assumption becomes invalid, the argument for exemption from specific direction by the representatives of the public interest also lapses.

IV

If ideally corporations ought to be conducted primarily in the interest of the stockholders, this does not mean that the law as it stands fully achieves this, or even that, if they were left unregulated by law, the market would necessarily produce such developments as to make the interest of the stockholders prevail. The general philosophy of government from which I am approaching these problems makes it probably expedient that, before I proceed to ask what particular legal arrangements would seem desirable, I devote a few paragraphs to the question why there should be a need for any special regulation of corporations and why we should not be content to let the market develop appropriate institutions under the general principle of freedom of contract.

Historically, the need for the deliberate creation of special legal institutions in this field arose, of course, out of the problem of limited liability and the desire to protect the creditors. The creation of a legal person capable of entering contracts, for which only the separate property of the corporation and not all the property of the owners was liable, required special legislative action. In this sense limited liability is a privilege and it is a valid argument to say that it is for the law to decide on which conditions this privilege is to be granted.

I shall also state only briefly what I have argued at length in another connection,[1] that 'freedom of contracts', like most freedoms of this kind, does not mean that any contract must be permitted or be made enforceable, but merely that the permissibility or enforceability of a contract is to be decided by the general rules of law and that no authority has power to allow or disallow a contract on the basis of the merits of its specific contents. I am not at all sure that in the field of corporations any kind of contract should be generally prohibited or declared generally invalid. But I am firmly convinced that modern use of the corporate form of organization requires that there should be a standard type of rules

[1] *The Constitution of Liberty*, 1960, pp. 230–1.

applying to all corporations bearing a description reserved to this type so that, for example, any corporation designated by the addition of 'Inc.' to its name should thereby subject itself to a known standard type of rules. I see little reason for making such rules strictly mandatory, or not allowing other types of corporations explicitly described as 'special'. If the public is thus warned that in the particular case the standard rules do not apply, it will probably look very carefully at the provisions of any corporate charter which differs from the standard type.

The problem I want to consider is, thus, whether the rules for the standard type of corporation should, to a much greater degree than is the case at present, be governed by regulations which assure that the interest of the stockholder shall be paramount. I believe this to be the case and wish here to indulge in some bold mental experimentation with regard to the means of giving the stockholders greater powers in this respect. It seems to me that in this field the possibilities of arrangements different from those to which we are accustomed are all too little considered, and that the 'apathy' and lack of influence of the stockholder is largely the result of an institutional set-up which we have wrongly come to regard as the obvious or only possible one. I shall not be surprised if the experts on corporation law should at first regard my suggestions as wildly impracticable and am even prepared to admit that, under the present system of taxation and under current monetary policies, at least the first of the two possibilities I shall consider may do more harm than good. This, however, is no reason for not seriously examining these possibilities, even if it were only in order to free ourselves from the belief that the developments which have taken place were inevitable. It is probable that, on the two chief points I want to consider, the existing arrangements were adopted, not by deliberate choice and in awareness of the consequences, but because the alternatives were never seriously considered.

V

If today the actual influence of the stockholder on the conduct of the corporation is small and often negligible, this is probably due, more than to any other fact, to the circumstance that he has no legally enforceable claim to his share in the whole profits of the corporation. We have come to regard it as natural that a majority decides for all what part of the profits is to be distributed and what part to be reinvested in the corporation, and that on this question the stockholders will normally act on the recommendation of the management. It seems to me that nothing would produce so active an interest of the individual stockholder in the conduct of a corporation, and at the same time give him so much effective power, as to be annually called upon individually to decide what part of his share in the net profits he was willing to reinvest in the corporation.[2] It would still be for the management to say what part of the profits it thought it could profitably use as additional capital and to recommend that additional shares be offered to stockholders who wish to reinvest part or all of their profits in the corporation. But it should normally be for the individual stockholder to decide whether he wants to make use of this opportunity or not.

It is evident that this would be desirable only in conditions of a stable currency where paper profits corresponded to real profits and under a system of taxation different from the present. But disregarding for the moment these obstacles to the present adoption of the principle, it seems to me that this one change would go very far towards making stockholder control of the corporation a reality, and that it would at the same time limit the growth (and probably even the existence) of individual corporations to what is economically desirable. I need not ask here how far the allegations about an excessive expansion of corporations through ploughing back of profits are in fact justified. That with the existing arrangements this is at least a distinct possibility and that the natural bias of the management will tend in this direction can hardly be denied.

It might at first be thought that the striving for the power which an increase of total assets confers on management will also make it aim at maximizing profits. This, however, is true only in a sense of this term different from that in which we have used it and in which it can be maintained that maximizing profits is socially desirable. The interest of a management striving for control of more resources will be to maximize aggregate profits of the corporation, not profits per unit of capital invested. It is the latter, however, which should be maximized if the best use of the resources is to be secured.

VI

So far as the individual stockholder is concerned, it is in general to be assumed that his interest is solely to obtain the maximum direct return from his holdings of the shares of a particular corporation, whether this be in the form of dividends or of appreciation, or in the short or in the long run. It is conceivable that even an individual stockholder may use a controlling influence to direct the activities of a corporation so that the

[2] Cf. Louis O. Kelso and Mortimer Adler, *The Capitalist Manifesto*, New York (Random House), 1958, p. 210.

gain will accrue mainly, not to that corporation, but to another corporation or firm where his share of the profit thus obtained would be even greater. Though possible, this is not a very likely situation to occur in the case of individual stockholders, not only because it would require very large resources but even more because such a manœuvre would probably be rather transparent and would be regarded as dishonest.

The situation is different, however, where the shares of one corporation are owned by another corporation, and nobody seriously questions that any control thus exercised by the second corporation over the first can legitimately be employed to increase the profits of the second. In such a situation it is clearly possible, and not unlikely, that the control over the policy of the first corporation will be used to channel the gains from its operations to the second, and that the first would be run, not in the interest of all its stockholders but only in the interest of the controlling majority. When the other stockholders discover this it will be too late for them to apply any remedy. The only possibility they will have is to sell out—which may be just what the corporate stockholder wants.

I must admit that I have never quite understood the *rationale* or justification of allowing corporations to have voting rights in other corporations of which they own shares. So far as I can discover, this was never deliberately decided upon in full awareness of all its applications, but came about simply as a result of the conception that, if legal personality was conferred upon the corporation, it was natural to confer upon it all powers which natural persons possessed. But this seems to me by no means a natural or obvious consequence. On the contrary, it turns the institution of property into something quite different from what it is normally supposed to be. The corporation thereby becomes, instead of an association of partners with a common interest, an association of groups whose interest may be in strong conflict; and the possibility appears that a group which directly owns assets amounting only to a small fraction of those of the corporation, may, through a pyramiding of holdings, acquire control of assets amounting to a multiple of what they own themselves. By owning a controlling interest in a corporation which owns a controlling interest in another corporation and so on, a comparatively small amount owned by a person or group may control a very much bigger aggregation of capital.

There seems to me to exist no reason why a corporation should not be allowed to own stock of another corporation purely as an investment. But it also seems to me that such stock, so long as it is owned by another corporation, should cease to confer a right to vote. Technically this could perhaps be effectively enforced only by permanently setting aside some part of the stock as non-voting shares and permitting only those to be held by other corporations. I am not concerned, here, however, with the practical details. The point I want to bring out is simply that the possibility of the control of one corporation by another opens up the possibility of the complete and perfectly legal control of large resources by persons who own only a small fraction of them, and of the use of such control in the interest of that group only.

The possibility of such an indirect, chainwise ownership of the stock of corporations is probably the second factor which has accentuated the separation of ownership from control and has given management, i.e., a few individuals, powers far exceeding those which their individually owned property could ever confer upon them. This development has nothing to do with the essence of the institution of the corporation as such, or with the reasons for which the privilege of limited liability was conferred upon them. In fact, if anything, it seems to me to be contrary to, rather than a consequence of, the conceptions on which the system of private property rests—an artificial separation of ownership and control which may place the individual owner in the position where his capital is used for purposes conflicting with his own and without his even being able to ascertain who, in fact, possesses the majority of votes. With the grant of voting rights to corporate stockholders the general presumption that the corporation will be run by persons whose interests are the same as those of the individual stockholder is no longer valid.

I will not pursue this possibility further to ask whether these considerations suggest that merely industrial corporations should be deprived of the voting power on the stock of other industrial corporations which they hold, or whether the principle should be extended also to financial corporations. Offhand I can see no reason for allowing such a distinction. Whatever desirable financial activities require that a firm should exercise the voting rights in a corporation could probably be performed without the privilege of limited liability.

Perhaps I should add that it seems to me that in recent years economists have been looking at corporation law (so far as they did so at all!) much too exclusively from the angle of whether it favoured the creation of monopoly positions. No doubt this is one important consideration which we ought to keep in mind. But it is certainly not the only one and perhaps not even the most important. The justification of the corporation is based on the conception that its managers will have to run it in such a manner that the whole of the capital it raises will be used in the most profitable way, and the public at large is certainly under the im-

pression that the law is designed to assure this. So long as the corporations are run by representatives of the majority of the true owners, there is at least a strong probability that this will be the case. But somebody who represents merely the majority of a majority, and whose interests may well be better served if he does not have to share the profit from his control of the corporation with those who have provided the greater part of the capital, may well pursue different aims. A legal situation which makes it theoretically possible that this position may arise in any corporation after the stockholders have committed their capital to it and have no remedy cannot be regarded as satisfactory.

VII

I have considered these two possibilities of changes in corporation law not so much because of their specific merit but as illustrations of the degree to which future developments depend on the legal framework we provide for them. They were meant to show that the complete separation of management from ownership, the lack of real power of the stockholders, and the tendency of corporations to develop into self-willed and possibly irresponsible empires, aggregates of enormous and largely uncontrollable power, is not a fact which we must accept as inevitable, but largely the result of special conditions which the law has created and the law can change. We have it in our power to halt and reverse this process if we want to. Even the two changes in the law I have considered would probably be much more far-reaching in this respect than is at first apparent or could be indicated in a few paragraphs.

Let me repeat, in conclusion, that to me the chief merit of these changes would seem to be that they would tie management much more effectively than is now the case to the single task of employing the capital of their stockholders in the most profitable manner and would deprive them of the power of using it in the service of some 'public interest'. The present tendency not only to allow but to encourage such use of corporate resources appears to me as dangerous in its short-run as in its long-run consequences. The immediate effect is greatly to extend the powers of the management of corporations over cultural, political, and moral issues for which proven ability to use resources efficiently in production does not necessarily confer special competence; and at the same time to substitute a vague and indefinable 'social responsibility' for a specific and controllable task. But while in the short run the effect is to increase an irresponsible power, in the long run the effect is bound to be increased control of corporations by the power of the state. The more it

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comes to be accepted that corporations ought to be directed in the service of specific 'public interests', the more persuasive becomes the contention that, as government is the appointed guardian of the public interest, government should also have power to tell the corporations what they must do. Their power to do good according to their own judgment is bound to be a merely transitory stage. The price they would soon have to pay for this short-lived freedom will be that they will have to take instructions from the political authority which is supposed to represent the public interest. Unless we believe that the corporations serve the public interest best by devoting their resources to the single aim of securing the largest return in terms of long-run profits, the case for free enterprise breaks down.

I cannot better sum up what I have been trying to say than by quoting a brief statement in which my colleague Professor Milton Friedman expressed the chief contention two years ago: 'If anything is certain to destroy our free society, to undermine its very foundations, it would be a wide-spread acceptance by management of social responsibilities in some sense other than to make as much money as possible. This is a fundamentally subversive doctrine.'[3]

[3] The Social Science Reporter's Eighth Social Science Seminar on 'Three Major Factors in Business Management: Leadership, Decision Making, and Social Responsibility', March 19, 1958. Summary by Walter A. Diehm, Graduate School of Business, Stanford University.

CHAPTER TWENTY-THREE

*The Non Sequitur of the 'Dependence Effect'**

For well over a hundred years the critics of the free enterprise system have resorted to the argument that if production were only organized rationally, there would be no economic problem. Rather than face the problem which scarcity creates, socialist reformers have tended to deny that scarcity existed. Ever since the Saint-Simonians their contention has been that the problem of production has been solved and only the problem of distribution remains. However absurd this contention must appear to us with respect to the time when it was first advanced, it still has some persuasive power when repeated with reference to the present.

The latest form of this old contention is expounded in *The Affluent Society* by Professor J. K. Galbraith. He attempts to demonstrate that in our affluent society the important private needs are already satisfied and the urgent need is therefore no longer a further expansion of the output of commodities but an increase of those services which are supplied (and presumably can be supplied only) by government. Though his book has been extensively discussed since its publication in 1958, its central thesis still requires some further examination.

I believe the author would agree that his argument turns upon the 'Dependence Effect' explained in Chapter XI of the book. The argument of this chapter starts from the assertion that a great part of the wants which are still unsatisfied in modern society are not wants which would be experienced spontaneously by the individual if left to himself, but are wants which are created by the process by which they are satisfied. It is then represented as self-evident that for this reason such wants cannot

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