Pre-Publication Draft; Not for Distribution
Forthcoming in *Dædalus* 142 (2) (Spring 2013)

The American Corporation

Ralph Gomory & Richard Sylla

Abstract: The United States from its earliest years led the world in making the corporate form of business organization widely available to entrepreneurs. Starting in the 1790s, corporations became key institutions of the American economy, contributing greatly to its remarkable growth. This essay reviews the evolution of corporations across several eras of the country's history. The most recent era is marked by a shift away from a stakeholder view of corporate interests and purposes to one dominated by profit and shareholder-value maximization. We strongly question whether this shift has been beneficial to the country as a whole. If our assessment is correct, there is a need to find ways of inducing corporations to act in ways that produce better societal outcomes. We therefore explore ways–including some suggested by the history of U.S. corporations–in which corporate interests and the public interest might become better aligned.

> Great corporations exist only because they are created and safeguarded by our institutions; and it is therefore our right and our duty to see that they work in harmony with those institutions.
> –Theodore Roosevelt, First Annual Message to Congress, 1901

Questions about the actions and purposes of American corporations have been with us as long as corporations themselves. Both the questions and the answers to them have varied widely over time. The Occupy Wall Street movement that began in New York City in September 2011, spreading thereafter to other cities, raised or reiterated some of the basic questions about how well these American institutions work. The questions being raised today cover a wide range of issues.

Why, during the ongoing financial and economic crises that broke out beginning in 2007, did large financial institutions and industrial firms teetering on the brink of failure–often because of their own misguided strategies and decisions–get bailed out by the federal government? Why did the government seemingly do much less for homeowners facing foreclosures on houses now worth less than the mortgage debt incurred to buy them, perhaps because they had lost their jobs in the economic downturn and could not afford the mortgage payments due?

Why do the profits of American corporations and the compensations of their executives stay high and even rise in some cases while jobs disappear and both economic growth and median family incomes stagnate? Why does the judicial branch join in to strengthen the influence of corporations, financial and nonfinancial, as with the Supreme Court's *Citizens United* decision in 2010? That decision granted corporations relatively unlimited free-speech rights to spend corporate funds in electoral politics.

It is not the first time in U.S. history that people have wondered whether ours is a government of the people or a government of the corporations, by the corporations, and for the corporations. Such fears are as old as the republic. They were present in the 1790s, when the United States began to lead the world in the development of the corporation as the most dynamic form of modern business enterprise. They arose again in the financial and economic crises of the late 1830s and early 1840s, after state legislatures had created thousands of corporations. In the decades around the turn of the twentieth century, when many corporations became very large, the fear of corporate power resurfaced, leading to antitrust laws and federal regulation. The crises of the Great Depression led to further restraints on the financial and economic powers of corporations.

If there is any surprise about the current crisis, it is not that worries about corporate power and its abuse are once again being raised, but that so little is being done about them in comparison with the reforms of the 1840s, the Progressive Era, and the New Deal. Could we be witnessing the ultimate triumph of the corporation, one in which corporate rights and privileges vastly outweigh corporate social responsibilities?

Americans have always viewed corporations with mixed feelings. On the one hand, a corporation with limited liability and endowed with a long life is an attractive vehicle for numerous investors to pool their individual capitals, receiving tradable shares of the company in return. Pooling of capital makes possible large, long-term investments that can achieve economies of scale and scope in the production and distribution of goods and services that are beyond the capabilities of sole proprietorships and partnerships. Indeed, one of the less appreciated reasons for the rapid rise of the U.S. economy in the nineteenth century in comparison to other nations was the relative ease of obtaining a corporate charter in America.

On the other hand, inherent in the corporate form are problems of conflicting goals. Will the managers of corporations manage them in the interests of the shareholder-owners? Or will the managers act in their self-interest? Will corporate managers take into account the interests of employees, customers, suppliers, lenders, and the polity that made the corporation possible?

Inevitably, these problems of corporate goals that have arisen throughout the history of the American corporation are still with us. Our essay outlines how they have been addressed in several distinct eras of U.S. corporate development. This history perhaps can inform how we might deal with them now.

We conclude by strongly questioning whether today's dominant corporate goal–profit maximization–is beneficial to the country as a whole.

* * *

In the period from the 1790s to the 1860s, the United States led the world in modern corporate development. Recent research provides the first comprehensive look at corporate development, revealing that U.S. states from 1790 to 1860 chartered 22,419 business corporations under special legislative acts and several thousand more under general incorporation laws that were introduced mostly in the 1840s and 1850s.[1] These totals far exceed the number of corporations created in any other country (most likely in all other countries combined) during that time. The United States thus became what might be called the first *corporation nation*.

[1] Robert E. Wright and Richard Sylla, "Corporate Governance and Stockholder/Stakeholder Activism in the United States, 1790–1860: New Data and Perspectives," in *Origins of Shareholder Advocacy*, ed. Jonathan G.S. Koppell (New York: Palgrave Macmillan, 2011), 231–251; Richard Sylla and Robert E. Wright, "Corporation Formation in the Antebellum United States in Comparative Context," forthcoming in *Business History* (2013).

Most of the early American corporations, operating within a state or in a city or town, were small by later standards. The largest were banks and insurance companies, joined later in the era by railroads and manufacturers. Stockholders, often locals, could monitor corporate operations firsthand, and they were more directly involved in corporate affairs than would later be the case. Stockholders' meetings were frequent and actually provided guidance for management. Passive stockholders could keep an eye on their investments by checking prices in securities markets and by observing the dividends they received, which in this era accounted for the lion's share of corporate net earnings.

Legislative chartering meant that charters could be tailor-made for each corporation, with its powers, responsibilities–including those to the community–and basic governance provisions carefully specified.[2] Most charters were not perpetual, but rather had set terms of years and had to come up periodically for renewal, a constraint on corporate malfeasance. Voting rules for shareholders in elections of directors and other corporate matters varied. They were not always the modern norm of one vote per share, which favors large-block shareholders. Legislative chartering could easily be corrupted, however, with incumbent corporations using money and influence to defeat charters for potential competitors, and would-be corporations using the same tools to gain charters.

General incorporation laws, also a modern norm, were introduced late in the antebellum era as a way to avoid the corruption involved in legislative chartering as well as what was perceived as too close a relationship between corporations and the states. Under general laws, any group of incorporators meeting the specifications of the law could receive a charter, the granting of which became an administrative rather than legislative function of government. Access to the corporate form became more open–a gain for society. But state oversight of the creation and monitoring of corporations was reduced, which had costs in terms of corporate governance.

* * *

From the 1860s to the 1930s, most corporations remained small (as is still true), but growing numbers of them became very large and operated nationwide and even multi-nationally. Large corporations required professional managers, who often had limited or no ownership shares. These "Berle-Means" corporations, so named after the authors of a famous 1932 book, *The Modern Corporation and Private Property*, effectively separated ownership (shareholders) from control (management), marginalizing the influence of owner-shareholders in corporate affairs.

In this era, external checks on the possibility that managers would behave opportunistically against the interests of owners and anti-socially against the larger interests of the country came in two forms: investment bankers and government. Large corporations often had to access capital markets by selling shares and bonds, a process in which investment bankers served as intermediaries. These bankers had an interest in corporate governance to assure the investors who had purchased corporate securities from them that their investments were sound and secure. They exercised that interest by monitoring their corporate clients, even going so far

[2] In this era, states would often charge a bonus for chartering a corporation. States also invested in corporations, receiving dividend incomes from them. Sometimes a corporate charter would require the company to provide funding for what otherwise might be a publicly funded organization. And states taxed corporations in various ways. See Richard Sylla, John B. Legler, and John J. Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790–1860," *Journal of Economic History* 47 (1987): 391–403; and John J. Wallis, Richard Sylla, and John B. Legler, "Interaction of Taxation and Regulation in Nineteenth-Century U.S. Banking," in *The Regulated Economy: A Historical Approach to Political Economy*, ed. Claudia Goldin and Gary D. Libecap (Chicago: University of Chicago Press, 1994), 121–144.

as to place bank representatives on corporate boards. To many Americans, however, such banker influence was suspect, and charges of banker dominance and a "money trust" caused investment bankers late in this era to retreat from their monitoring and oversight roles in corporate affairs. That, of course, served to increase the powers of corporate managers.

Americans' suspicions about large banks and investment bankers were also directed at large corporations. The Gilded Age of the late nineteenth century featured the rise of the Robber Barons, both the business leaders who amassed great power and wealth in the rise of mass-production and mass-distribution industries, and the great financiers of Wall Street who collaborated with them. Popular politicos, such as trust-busting Theodore Roosevelt, adopted ordinary Americans' concerns about the concentration of wealth and power, leading to the passage of antitrust laws and corporate regulation at both the federal and state levels. The purported goal was to prevent or rein in monopoly, but in some cases the application of antitrust laws and regulations detracted from corporate efficiency and protected inefficient producers from more efficient competitors. (American political economy often protects particular competitors from competition in the name of avoiding monopoly.)

* * *

The period from the 1930s to the 1980s began with the Great Depression, which put the financial and corporate sectors under a cloud, resulting in a host of New Deal reforms. In finance, the Glass-Steagall Act (1933) separated investment banks and commercial banks, ramped up federal regulation, and introduced deposit insurance. A series of securities acts (1933, 1934, and 1940) compelled publicly traded corporations to disclose more (and more timely) information to their stockholders and the general public. The acts also provided regulatory oversight of securities trading and investment companies.

Corporations recovered much of the prestige they lost during the Depression through their contributions to the successful outcome of World War II. The lessons about the economy learned from World War II varied with the eye of the beholder. To some, the overwhelming factor in the U.S. contribution to the war effort was our immense ability to manufacture. That capacity was certainly there: already by the 1920s, the United States not only led the world in production of the key industrial products, steel and electricity, but also led in their per-capita production. When the United States entered the war, President Franklin Roosevelt created the War Production Board, comprised of industry leaders. Under their command, the country moved with incredible speed from civilian to military production. Airplanes in enormous numbers were produced in place of cars. U.S. shipbuilding capacity produced carrier-led fleets whose eventual scale dwarfed those of America's enemies.

But there was another influential way of looking at the war's outcome. This view, popular in academic and intellectual circles, attributed the favorable outcome to Allied scientific superiority. Radar played a key role in deflecting the German aerial assault on Britain following the fall of France and in determining the course of the war in the Pacific. The atomic bomb ended the war with Japan without the massive loss of American troops that a ground assault on the Japanese home islands almost certainly would have entailed.

Yet the wartime radar came from England, and European science underpinned the atomic bomb. Before the war, American science was not significant on a world scale. Science in this country, moreover, was not viewed as practical. The great productivity of the United States had its footing in mass production technologies and mass distribution capabilities, not in science.

The prestige of science, and the appreciation of its practicality, rose sharply following the war. Academia and government, especially after Sputnik (1957) and in the face of the

intensifying Cold War, came together on the idea that the United States should lead the world in science. The National Science Foundation came into being to fund academic research in science and engineering. Cold War national defense budgets underwrote the transfer of cutting-edge science and engineering to a cadre of corporate military contractors. They left the more mundane area of manufacturing to established firms using older mass production technologies. At the end of his two terms in office (1953–1961), President Dwight Eisenhower, a military hero of World War II, would warn the country of a rising "military-industrial complex."

For two decades after 1945, large American corporations were subject to little international or domestic competition because of their oligopolistic market structures. Dividend payouts declined as corporations retained more and more of their profits to fund much of their investment. Because of New Deal reforms and profit retention, the financial sector, which earlier had both financed and strongly influenced corporate affairs, was essentially reduced to advisory and service roles. Stockholders did not mind lower dividends because prosperous times increased the value of their shares, and regulation by the Securities and Exchange Commission increased investor confidence that Wall Street provided a level playing field.

Managers still controlled corporations, and they exercised their power by choosing directors. Often these included top managers themselves. Outside directors chosen by management were obviously beholden to management. Stockholders, the putative owners, had little say. The Berle-Means corporation remained alive and well, enjoying its heyday in the two decades after World War II. Corporations did so well in this period because of a strong American economy, a worldwide demand for American products and know-how, and a lack of competition from abroad. A widespread, though not unanimous, view was that corporate and country prosperity were closely linked. It was during this period of prosperity in the 1950s that General Motors CEO Charles Wilson, in hearings related to his nomination by Eisenhower to be Secretary of Defense, made his famous statement that "what was good for our country was good for General Motors and vice versa."

In the early postwar decades, the problem of corporate goals seemed under control. Managers in general did not feather their own nests at the expense of owners and other stakeholders. J. K. Galbraith, a keen observer of corporate America, explained that the system worked as well as it did because managerial power was faced by countervailing powers in the form of big labor and big government. Unions were at their strongest in these decades, in part because of New Deal labor reforms, and they pushed for higher wages as well as health care and retirement benefits from corporate employers. As for big government, federal regulatory and antitrust laws put in place from the 1880s through the 1930s remained on the books, and postwar Congresses and administrations added a host of new laws.

The interests of managers, stockholders, workers, consumers, and society seemed well aligned. And they needed to be. Aside from purely economic issues, the United States and the Soviet Union were fighting a Cold War that was in significant part a war of ideas. Communism as practiced and advocated by the U.S.S.R. asserted that it would deliver the workers of the world from the slavery of capitalism and raise their standard of living. Soviet ideology dominated states of Eastern Europe, engulfed China and Cuba, and supported strong Communist parties in many parts of the world, including important West European countries such as France and Italy.

Fortunately, the widely shared growth and prosperity in the United States supported the idea that capitalism could be both effective and benign. Even the Soviet leader Nikita

Khrushchev, in a widely quoted remark on a visit to the United States, admitted grudgingly that "the slaves of capitalism live well."

For several decades, corporate leaders recognized the claims of various stakeholders. As late as 1981, the Business Roundtable issued a statement recognizing the stewardship obligations of corporations to society:

> Corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs, and build the economy.
>
> [. . .]
>
> That economic responsibility is by no means incompatible with other corporate responsibilities in society.
>
> [. . .]
>
> The issue is one of defining, and achieving, responsible corporate management which fully integrates into the entire corporate planning, management, and decision-making process consideration of the impacts of all operating and policy decisions on each of the corporation's constituents. Responsibility to all these constituents *in toto* constitutes responsibility to society. . . . Business and society have a symbiotic relationship: The long-term viability of the corporation depends upon its responsibility to the society of which it is a part. And the well-being of society depends upon profitable and responsible business enterprises.[3]

Corporations thus for some decades after World War II were willing to accept a mix of goals; they aimed for good products, satisfied customers, a good effect on the community and nation, and a steady return to the shareholders. But that was about to change.

The economies of the rest of the non-Communist world began to revive. Foreign competition for the American market mattered more than ever because of the tremendous evolution of seaborne commerce in the form of container ships. Goods of every size made in one country could be shipped around the world to another nation at greatly reduced cost. Later, airborne freight also entered the picture for goods of more value per pound. The de facto protectionism provided by the oceans was being repealed by the march of transport technology.

Japan in particular, by providing government support and direction, emphasized manufacturing for export. It developed and adopted new and better manufacturing techniques, forging rapidly ahead in key industries ranging from automobiles, once the U.S. stronghold, to consumer electronics and, later, computer memories. American industry, used to easy success in an environment with limited competition, was slow to respond. Rising inflation and energy-price shocks further eroded American competitiveness. The U.S. dollar lost value compared to other leading currencies. The stock market languished. The easy years were over, and the 1970s saw a major slowdown in what had been steadily rising U.S. productivity, economic growth, and prosperity. Corporate America was in trouble.

* * *

The period from the 1980s to the present has been marked by a major shift away from a broad view of stakeholder interests to an almost exclusive focus on shareholder value. Galbraith's countervailing powers had in fact begun to break down by the 1970s. Declining union membership gradually reduced the influence of big labor on corporate managers. Corporations hastened the trend by closing factories in the old manufacturing belt of the Northeast and

[3] The Business Roundtable, "Statement on Corporate Responsibility," October 1981, 12.

Midwest, where unions were strong, shifting production to Sun Belt states that had long anti-union traditions. The old manufacturing areas became known as the Rust Belt.

Countervailing power weakened further as academics and others began to attack government antitrust and regulatory policies as misguided. They called for deregulation and increasingly placed government itself under scrutiny. Instead of working in the public interest, many argued, government practiced interest-group politics. Bureaucrats had their own interests–larger budgets, more authority, more employees–which had little to do with the public interest. Ronald Reagan, the popular president from 1981 to 1989, epitomized this new view when he famously said government wasn't the solution, it was the problem.

Academics came to the rescue of corporations, or so it seemed, with new theories of what corporate managers should do. Instead of catering to the interests of various stakeholders, as they had done in the good old days of the postwar era, managers would best serve owners and society in general, the academics argued, by single-mindedly working to maximize shareholder value. The stakeholder view was complicated; actions that are in the interests of some stakeholders may be counter to the interests of others. Higher wages may mean lower profits, and lower wages may mean higher profits.

In contrast, shareholder value was determined daily in the stock market, which the efficient-markets hypothesis showed to be good for measuring that value. The stock market, academics further argued, would identify good corporate managers–those who increased share prices–and would expose bad ones: those who didn't. Managers who failed to maximize shareholder value would be disciplined and even jettisoned by the market for corporate control, which featured hostile takeovers and leveraged buyouts financed by a rejuvenated and innovative financial sector. Society supposedly benefited because the corporate goal was now to make the total value of the enterprise, as measured by what it would take to buy it on the open market, as large as possible.

This academic doctrine fell on receptive ears. From a shareholder perspective, it put their interests in the driver's seat; the success of the company was to be measured by their return. From the point of view of corporate management, it was a mixed blessing. After all, corporate leadership was used to a great deal of independence, they took pride in having good products and being respected members of the community, and they dealt with their fellow workers and managers every day. Shareholders, in contrast, were a distant and uninformed mass to be dealt with by dividends. But in a world of profit maximization, profits could be measured every day and had to be reported every quarter.

This gap in the natural orientation of shareholders and corporate managers was well recognized in academia: it was simply the old principal-agent problem. And, the academics argued, it was not that hard a problem to solve. The solution was to give corporate leadership major stock options. When the stock went up, management benefited hugely. This approach aligned the interests of managers with those of the shareholders.

The stock-options solution cost the company and its shareholders nothing if the stock did not go up, so it was possible to vote the corporate leadership amounts of options that overcame any hesitancy. In fact, CEO compensation soared to previously unheard-of heights. And under many circumstances, a CEO did not have to be exceptional to profit from stock options. In the rising stock market of the 1980s and 1990s, compensations for all CEOs rose together. Certain practices in corporate governance helped generate this result. CEOs sometimes served simultaneously as chairmen of their boards. They invited other CEOs to serve on their boards and possibly chair the compensation committee, a favor that often was returned. CEOs and

boards hired compensation consultants that, perhaps unsurprisingly, seldom if ever recommended reducing CEO compensation.

Criticisms of CEO compensation usually elicited a response such as, "He created $2 billion of increased value, why shouldn't he get $100 million of it?" This attitude implied that the efforts of an entire company, with tens of thousands of employees, were the result of a single CEO or top-management team. John F. Welch, CEO of General Electric from 1981 to 2001, is a prominent example. In the 1980s, Welch was dubbed "Neutron Jack" for reducing GE employment by more than one hundred thousand (of about four hundred thousand) and for firing each year the bottom 10 percent of his managers. Welch also led the old manufacturing company into financial services, which came to account for a large proportion of GE's profits. Shareholder value and profits soared under Welch, whose stock options made him a very wealthy man. In 1999, *Fortune* magazine named him Manager of the Century. But Welch's initiatives would lead to problems for GE and his successor after he retired.

The principal-agent problem often did seem to be solved by the stock-option form of remuneration. Employees, however, were not discussed in the stock-option solution to the principal-agent problem, although they were affected by it. Wages, executive compensation, and profits all come out of the total "value added" by a corporation. With the extensive use of stock options, executive compensation and profit, which is reflected in stock price, are linked together. Both improve if wages can be held down. Thus, holding down wages became in the interest of both management and shareholders.

The path that the division of corporate value added has taken since 1980 is reflected in data on productivity, pay, and income shares. From 1947 to 1979, productivity rose 119 percent, average compensation of production and non-supervisory workers (who constitute more than four-fifths of the private-sector labor force) grew 100 percent, and the share of national income received by the top 1 percent of earners (which would include most of top corporate management) ranged from 9 to 13 percent. From 1979 to 2009, in contrast, productivity rose 80 percent, worker compensation rose 8 percent, and the top 1 percent of earners increased their share of national income to more than 23 percent.[4] The changes in compensation trends and top-income shares that began in the 1980s are striking.

Equally striking is the change in tone that top corporate executives take with regard to corporate responsibilities. In 1981, as earlier noted, the Business Roundtable emphasized stakeholders. But by 1997, the same organization of prominent senior executives stated:

> [T]he principal objective of a business enterprise is to generate economic returns to its owners. . . . [I]f the CEO and the directors are not focused on shareholder value, it may be less likely the corporation will realize that value.[5]

Stock options indeed had apparently aligned the interests of management with those of shareholders.

Does the emphasis on maximizing shareholder value invariably lead to higher stock prices? The evidence is mixed. Stock price indexes did trend upward from late 1982 to early 2000. But at the end of 2011 they had barely changed from the levels reached in 2000. And even

---

[4] See Robert B. Reich, "The Limping Middle Class," *The New York Times*, September 4, 2011, http://www.nytimes.com/2011/09/04/opinion/sunday/jobs-will-follow-a-strengthening-of-the-middle-class.html?_r=1.

[5] "Statement on Corporate Governance," Business Roundtable White Paper, September 1997, 1–2, as quoted in George P. Baker and George David Smith, *The New Financial Capitalists: Kohlberg Kravis Roberts and the Creation of Corporate Value* (Cambridge: Cambridge University Press, 1998), 205–206.

if the emphasis on stock price results in higher stock prices, who benefits? Is maximizing shareholder value good for the country as a whole? To answer that question, one must ask who owns the stock. If, for example, stock ownership were spread evenly across the U.S. population, rising stock values would have a widely beneficial effect. On the other hand, if one person were to own all stock, it is doubtful that it would be in the national interest to have all corporations and their employees working to make that one person even wealthier, especially if they had to hold down wages to do it.

The actual situation is in between, but it is close enough to the second case to be worth mentioning. The most recent (pre-crisis) data show that the wealthiest 1 percent of Americans own roughly one-third of the value of all shares, that the wealthiest 5 percent hold more than two-thirds of the value of all shares, with the other third spread over the remaining 95 percent.[6] Ownership of U.S. corporations is highly concentrated.

* * *

The preceding section traced the grand outlines of what has been happening in the U.S. economy in recent decades. But other changes are transpiring underneath this picture. One major change is the rise of the Asian economies, especially that of China.

China has experienced rapid economic growth since the late 1970s, when leaders of the one-party Communist state turned their economy in a capitalist direction. China's rapid industrialization and export orientation have had a major negative impact, via imports of Chinese goods, on U.S. productive capability, especially in the area of manufacturing. One result is an enormous imbalance of trade, as imports from China are not balanced by a roughly equivalent counterflow of exports from the United States. Instead, China accumulates huge dollar balances and then lends them back to the United States by purchasing U.S. debt securities. The trade imbalance has led to a large increase in the availability of cheaper consumer goods. Wal-Mart, among other retailers, is a great outlet for these Chinese goods. While this has benefited American consumers, it has come at a high cost to parts of the American economy.

China's approach to trade is best described as traditional mercantilism, a pattern of government policies aimed at advancing a nation's industries in world trade. China's actions, which include mispriced currency, subsidies, and the rapid appropriation of foreign know-how, allow many Chinese industries to compete on the world scene with prices and capabilities that would otherwise have required decades to attain. The effect on many American industries has been devastating. Business scholars Gary Pisano and Willy Shih have enumerated the long list of high-tech goods no longer made in the United States.[7]

Meanwhile, U.S. global corporations, in their normal pursuit of profits, are strongly aiding the industrialization of China. They are also to a large extent using China as a manufacturing base to supply the U.S. market. Either alone or in joint enterprises with Chinese corporations, U.S. corporations are building plants in China that enhance both that country's productive abilities and its technical know-how. The goods imported from these enterprises contribute largely to the enormous imbalance of trade. The result is $2–3 trillion at the disposal

[6] Edward N. Wolff, "Recent Trends in Household Wealth in the United States: Rising Debt and the Middle-Class Squeeze–An Update to 2007," Working Paper No. 589 (Annandale-on-Hudson, N.Y.: Levy Economics Institute of Bard College, March 2010).

[7] Gary P. Pisano and Willy C. Shih, "Restoring American Competitiveness," *Harvard Business Review* 87 (7–8) (July/August 2009).

of the Chinese government for the purchase of more U.S. Treasury securities–or, as seems more likely in the future, for the acquisition of American companies and their technologies. In addition, U.S. corporations are increasingly locating their R&D in China, providing a further and direct way for China to acquire American technologies.

Competition from China has highlighted two general attitudes toward U.S. manufacturing. Some lament the destruction of American manufacturing, which is traditionally high wage, R&D intensive, and the greater part of U.S. exports in international trade. They ask where our manufactured goods will come from if we do not make them and do not have anything on the same scale to trade for manufactured imports.

Others believe in a "new economy" in which manufacturing is off-shored. America creates the design; those with developed manufacturing skills and perhaps lower wages build what we design. America specializes in R&D and innovation; the duller and older things that have become commodities are made abroad. This view is intrinsically appealing. It is pleasant to imagine that inventive Americans will design new products and leave the grunt work of making them to other nations. Although this view is popular in some academic and financial circles, its quantitative underpinnings are weak. R&D is simply too small a part of industrial activity across the board to replace the loss of manufacturing.[8]

* * *

What does theory have to tell us about the overall impact of these developments? Many economic observers believe that when you lose manufacturing, for example, it is because your comparative advantage is somewhere else; that it is more beneficial to let market forces move you in the direction of your comparative advantage; and that it is a mistake in these circumstances to try to hold on to what you once had.

These views, however, follow most standard economic models in assuming that countries have fixed capabilities. With capabilities fixed, the action of market forces will indeed respond in the way described, and thus the free-market, free-trade result is beneficial. But what are the effects on the home country when a trading partner changes its capabilities? To be specific, what is the effect on the United States when China does not hold its capabilities fixed, but instead substantially improves them?

Economic theory does not assert that when a trading partner improves its capabilities, and then market forces act on these new capabilities, the new free-trade result is better for the home country than the situation that existed before the change. In fact, it can be harmful.[9] According to standard models, a trading partner's initial development is good, but as that partner moves from less developed to more developed, further development can become harmful. The result is a decrease in the home country's GDP.[10] This theoretical result takes into account all the effects; it includes the consumer benefits of cheaper goods from the newly developed partner (China) as well as the negative impact of losing productive industries in the home country (the United States).

---

[8] See Ralph Gomory, "The Innovation Delusion," http://www.huffingtonpost.com/ralph-gomory/the-innovation-delusion_b_480794.html.

[9] Ralph E. Gomory and William J. Baumol, "A Linear Ricardo Model With Varying Parameters," *Proceedings of the National Academy of Sciences* 92 (1995): 1205–1207.

[10] Ralph E. Gomory and William J. Baumol, *Global Trade and Conflicting National Interests* (Cambridge, Mass.: MIT Press, 2000).

Hence, the simple assertion that free trade is beneficial does not enable us to conclude that China's development is good for the United States. (And recall that China's current approach is more accurately described as mercantilist than as free trade.) It is more reasonable to say that theory expects China's development to have a negative impact at some point. Indeed, that point has likely been reached.

We remarked earlier that U.S. global corporations are strongly aiding China's rapid development. *We cannot, therefore, ignore the possibility that the interests of our global corporations and the interests of our country may have diverged.*

* * *

Nobel laureate Michael Spence looks beyond U.S.-China trade in particular to describe the overall negative effect of globalization on the U.S. economy. Spence also goes beyond the overall economic effect to describe the effects on different parts of American society. He concludes that globalization has led to higher levels of unemployment, particularly in manufacturing industries that compete with imports, and that it has widened income disparities within the country.[11] Spence's analysis reminds us to consider not only how U.S. industries and corporations are faring on the world stage, but how well they are serving American citizens at home. To begin this discussion, we must first ask what we as Americans want from our corporations. Only then can we measure current circumstances against our ideals.

* * *

To do this sensibly we need a historical perspective on the corporation. It is important to remember that from the earliest times until the middle of the nineteenth century, most of the world's work was done on small farms or in small shops. This traditional world was dominated by agriculture and the need to provide food. Large organizations, with the exception of the army, the navy, and the church, were almost nonexistent. This was the world in which Adam Smith and David Ricardo lived and which they described in their influential economic writings.

The Industrial Revolution of the late 1800s changed this world. Steel mills and factories sprang up, and people migrated on a large scale to the new production centers. Economic activity became increasingly the province of large organizations. Agriculture itself gradually became more mechanized and less people-intense, and it was organized increasingly in large corporations.

These developments have fundamentally changed our way of life. The goods we consume today are too complex to be made at home, on a family farm, or in a small shop; they require large organizations to create them. You cannot manufacture a car in your garage; it takes a large-scale organization to do it. The food we eat is rarely produced by a family on a nearby farm, but is instead made by large organizations on highly mechanized farms with machinery produced by other large organizations, and then is transported on highly organized networks to huge outlets. The same is true of services; you cannot organize a telephone network on your own.

The goods and services we consume today are primarily created by organizations, not individuals. To contribute to the economy today, an individual usually must be part of an

[11] Michael Spence, "Globalization and Unemployment," *Foreign Affairs*, June 2011.

organization. Being part of an organization is what most people must do in the modern world to earn a living and support themselves and their families. Therefore, the fundamental social role of business organizations, usually corporations, is both to produce efficiently the goods and services that are consumed in the modern world and–equally important–to enable people to participate in that production, so that they earn a share of the value produced for themselves and their families.

With this background in mind, we suggest that Americans can reasonably expect two things from our corporations.[12]

> (1) Our companies should be productive, each contributing as much as possible to the total of goods and services produced in the United States. It is the sum of these efforts that makes America prosperous.
>
> (2) Our corporations should provide productive and well-paying jobs so that the value the companies create is widely shared by Americans. This widely shared wealth gives the nation and its people economic security and political stability.

These expectations sound very different from the present goal of maximizing profit and shareholder value. They are closer to the role that corporations played during the prosperous 1950s and 1960s, when interests other than those of the top executives and large shareholders were also taken into account.

If these are the goals, how well are U.S. corporations doing? They are doing well by their own criterion of maximizing profitability and (less certainly) shareholder value. In fact, major corporations have had record profitability in recent years, even though the nation has been racked with declining incomes, high unemployment, and languishing stock prices.

But corporations are not doing very well by the two criteria we list above. With respect to the first criterion, GDP has increased more slowly in recent years, and the most productive sectors affected by corporate globalization are no longer the growth areas of the U.S. economy. Our high-tech and manufacturing areas have been among the hardest hit. On the first criterion, therefore, we are hard pressed to award a grade better than C.

On the second criterion, we have seen only small returns to most Americans over the last thirty years, the period in which the shareholder view overtook the stakeholder view. Almost all the gains from increased productivity, as noted earlier, have gone to the top economic tier. The resulting concentration of wealth and its attendant political power threatens the nature of our democracy. Three decades of this realignment merits a low grade, charitably a D.

* * *

Currently, the dominant motivation of the American corporation is to maximize profits and raise stock price in the interest of shareholders. While this is often regarded as a legal requirement, it is not. Corporate directors owe their fiduciary duties not to the shareholders, as is often thought,

[12] See Ralph Gomory, "Country and Company: Part I–Divergent Goals," http://www.huffingtonpost.com/ralph-gomory/country-and-company-part_b_174875.html.

but to the corporation.[13] Indeed, it would be surprising if the law prescribed shareholder value as the only goal given that the Business Roundtable, as early as its 1981 statement quoted above, publicly urged the consideration of many other factors.

Despite its lack of legal standing, the sway of "maximizing shareholder value" appears absolute. In today's large corporations, shareholders are distant from the company and their sole attachment is to the shares they hold, although they usually hold them for only a short time. Corporate results, if the goal is shareholder value, are easily measured; companies that do not measure up will see a change of CEO or of the board, or possibly a hostile takeover.

If we assume that this motivation is unchangeable, then the road to better social outcomes must lie in making these outcomes more profitable for corporations. We begin by discussing ways to improve the performance of corporations on our first criterion, which, in homely terms, is about making a bigger total pie (GDP) for Americans without concern for how it is divided up.

* * *

Given the strong negative influence that Asian mercantilist policies have on our corporations, one measure that must be considered is *tariffs*. Tariffs have had a long history in this country. Although economists almost unanimously resist the imposition of tariffs and almost automatically support free trade, no economic theory says that persisting in free trade is the best response to mercantilism. Modern developments in strategic trade theory in fact suggest the opposite. Nor does the history of tariffs or other restrictive measures provide an unambiguous guide to their usefulness or harmfulness.

* * *

The situation in which tariffs are applied as well as the form of tariff can affect the outcome. In a 2003 *Fortune* article, Warren Buffett proposed what he called *import certificates*.[14] Buffett's import certificates, while certainly a form of tariff or quota, are closely connected to what economists refer to as *cap and trade*.

Cap and trade is familiar to economists through its application to air pollution. In the case of air pollution, the total of allowable emissions is decided on in advance and is called the cap. Pollution certificates are then issued, each allowing a certain amount of pollution, with the total of the certificate amounts equal to the cap. These certificates are then sold in an open market, and those companies with pollution most expensive to control end up with the certificates.

---

[13] Section 8.30(a) of the Model Business Corporation Act (which has been adopted in many states) reads as follows: "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation." The act then follows with an almost identical section on the duties of the corporate officers, also requiring them to act in the interests of the corporation.

[14] Warren Buffett and Carol J. Loomis, "The Nation's Growing Trade Deficit is Selling the Nation Out From Under Us," *Fortune*, November 10, 2003.

Similarly, a cap can be put on imports, and permits to import can be issued and traded. In order to balance trade, the cap (or total of import certificates issued) is set equal to, for example, the previous year's exports. If the U.S. government issues the certificates, it is a source of revenue. If the certificates are instead earned by exporters in quantities scaled to their exports, the price obtained by selling them in an open market becomes an incentive to export. As economies adjust to the presence of the certificates, the certificate value can be expected to move toward zero.

If other countries retaliate by imposing tariffs and reducing imports from the United States, the number of import certificates issued will automatically decrease so their ability to export their goods to the United States is also reduced. This creates an incentive not to impose tariffs. Alternatively, if they retaliate by adopting a similar import certificate system of their own, the result is a world of more balanced trade, a desirable outcome.

* * *

Another quite different but also traditional method employed in the United States is to use the individual or *corporate income tax* to bias individuals or corporations toward desired social goals. In the case of the individual, there are tax advantages given to promote homeownership, and in the corporate case there has been a reduction in the corporate income tax based on the company's growth in R&D spending.

What is suggested here is to use the corporate income tax to provide direct incentives for companies to have high value-added in the United States. While Asian countries have provided such incentives, usually by deals with individual companies, an approach better suited to the United States and to the capabilities of the American government would be an across-the-board approach: reward all companies for creating high value-added in the United States, whether they achieve that goal through R&D and advanced technology or by finding ways to improve production of goods and services.

One form that such an incentive could take would be to lower a corporation's income tax in proportion to the value added per U.S. employee. Such a tax could be made revenue neutral by having a high tax rate for unproductive companies and a low tax rate (or even a subsidy) for productive companies. Depending on the rates, the incentive could be strong or weak.

Many forms of this approach can be considered. An approach better suited to an economy struggling with unemployment would be to reward companies for their total value added in the United States rather than productivity or value added per employee. With such an incentive in place, a company moving work overseas would suffer a tax disadvantage.

There are many variants of these general approaches that can be considered. We are not alone in thinking that it is a direction worth considering. As Jeffrey Immelt, CEO of General Electric, stated in 2007: "If the U.S. government wants to fix the trade deficit, it's got to be pushed; GE wants to be an exporter. We want to be a good citizen. Do we want to make a lot of money? Sure we do. But I think at the end of the day we've got to have a tax system or a set of incentives that promote what the government wants to do."[15]

* * *

[15] An interview with Jeffrey Immelt, in *Manufacturing & Technology News*, November 30, 2007.

Next we need to consider the second goal, which bears on who gets how much of the bigger pie. The focus on shareholder value as the only corporate goal is a recent development. While it has the advantage of simplicity and measurability, it also pits wage-earners directly against those whose interest is mainly in share price: that is, the shareholders and top executives. There is no concept of sharing or distributing the fruits of greater productivity. Perhaps we should consider other forms of organization. The following suggestions are intended to provoke thought, not provide a solution. But we do think that such thought is needed.

Other forms of organization–namely, mutual corporations and cooperatives–have a significant history in the United States. In the insurance industry, the mutual form serves more than 135 million auto, home, and business policyholders; it accounts for 50 percent of the automobile/homeowners market and 31 percent of the business insurance market. Cooperatives are more common in Europe, but in the United States they have had a significant presence in agriculture, farm credit, federal home loan banks, rural electric service, mutual insurance, and credit unions. There is also a recent movement advocating so-called B corporations, which are required to create a benefit for society as well as for shareholders.[16] These corporations represent a return to the earliest concept of the corporation in U.S. history, which was to achieve a specific public purpose stated in the charter of incorporation.

Perhaps most interesting, however, is the possible evolution of the corporate form itself. As we remarked above, early corporations in the United States were legislatively chartered, with charters especially made for each corporation. Charters laid out the corporate responsibilities and basic governance procedures; often the charter was for a limited time, not perpetual. Such charters, whether given by states or by the federal government, could be a way of creating corporations that do better on the second of the two corporate goals we laid out, providing American workers with well-paid jobs.

One form of such a corporation could be a corporation that is pledged to be value-added maximizing rather than profit maximizing. Maximizing value added is measurable, just as maximizing profit is. Furthermore, as it is the sum of value added by individuals and organizations in a country that adds up to GDP, maximizing value added makes the total economic pie as large as possible, without specifying what share of the value added is to be wages and what is profit. This is the essence of our first goal. If management's compensation is tied to value added rather than profit, all parties–wage-earners, shareholders, and management–can gain from greater value added, and this is an incentive for them to work together to increase it.

Dividing the value added is where there is conflict, which the present profit-maximizing arrangement settles entirely in favor of those who are compensated by profit. This approach leaves out the wage-earners. We have seen the consequences of that division over the past thirty years.

In a world of companies devoted to maximizing value added, there could be many ways to divide the portion of the value added that is available for wages and profits. Some companies will give as much as they can to profits, making them indistinguishable from today's profit maximizers. They may find it easier to raise money in the stock market. Some companies may

[16] See http://www.bcorporation.net/.

choose to give more in wages, and they may find it easier to hire and keep good people. Some may choose to excel in being environmentally friendly.

Were such a change in the purpose of the corporation to be adopted we might become a nation with a great variety of companies, all in their different ways adding to the GDP and many adding to a better distribution of income, wealth, and, in turn, political power.

* * *

Adolf Berle and Gardiner Means, in the last chapter of *The Modern Corporation and Private Property*, expressed doubts about two views of the corporation. One was the view that the corporation belonged to its shareholders and ought to be for their sole benefit. They questioned this view because passive shareholders had ceased to have power over, or any responsibility for, the management of corporations. The other view was that the management that controlled a corporation, possessing powers obtained on a quasi-contractual basis, "can operate it in their own interests, and can divert a portion of the asset fund or income stream to their own uses." If these were the only two choices, Berle and Means said, "the former would appear to be the lesser of two evils."

But there was a third choice. Since passive shareholders had surrendered control of, and responsibility for, corporate management, and since managements had made no case that corporations should be operated in the interest of managers:

> They have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society. . . . [I]f the corporate system is to survive . . . the "control" of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity.[17]

American corporations from the 1930s to the 1980s appeared to follow Berle and Means's third choice, or what might be called the stakeholder view of the corporation. That changed when stock options came in to align the interests of shareholders and top managers, seemingly solving the conflict of shareholder and managerial interests that Berle and Means had exposed. With shareholders and management aligned, however, other interests took a back seat. Perhaps it is time to consider a different problem: *how do we align the actions of corporations with the broader interests of the country?*[18] This is the problem we have been addressing in the last part of this essay.

The great American corporations today are doing well for their top managers and shareholders, but this does not mean that they are doing well for the country as a whole. The growing concentration of income and wealth threatens both the long-range productivity of the country, through extensive off-shoring, and its long-range internal stability, through a growing concentration of wealth that carries with it political as well as economic dominance. These issues and what to do about them deserve more thought from the economics profession and, indeed, from all Americans.

---

[17] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932), 354–356.

[18] Economists might well consider this a different principal-agent problem.

Ralph Gomory, a Fellow of the American Academy since 1973, is Research Professor at the New York University Stern School of Business. He is President Emeritus of the Alfred P. Sloan Foundation. Before that, he spent thirty years at IBM, where he rose to become Director of Research and then Senior Vice President for Science and Technology. His publications include the book *Global Trade and Conflicting National Interests* (with William J. Baumol, 2000).

Richard Sylla, a Fellow of the American Academy since 2012, is the Henry Kaufman Professor of the History of Financial Institutions and Markets and Professor of Economics at the New York University Stern School of Business. He is chairman of the board of the Museum of American Finance. His publications include *Founding Choices: American Economic Policy in the 1790s* (edited with Douglas A. Irwin, 2011), *A History of Interest Rates* (with Sidney Homer; 4th ed., 2005), and *The State, the Financial System, and Economic Modernization* (edited with Richard Tilly and Gabriel Tortella, 1999).