

# The Crisis of Corporate Law: Rescuing the Great American Job Machine

## Broken Idol: how to reform corporate law to fix the great American job machine

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### INTRODUCTION: ECONOMIC AND IDEOLOGICAL CRISIS

Our major corporations are failing us. The giant institutions that helped propel the United State to extraordinary and widely shared middle class affluence have lost their way. It is time, therefore, for a serious look at how we control our most important economic institutions and how we can structure them to do a better job.

The current jobs recession has lasted an extraordinarily long time and left an extraordinarily large number of Americans without work. But our problems go well beyond the business cycle. Instead, they reflect a change in the economy and our large corporations over the last generation: on multiple levels, our institutions no longer seem to be working for all of us.

For the first time in the history of the United States, we've gone a full decade with no increase in the median wage.<sup>1</sup> American men of working age are, on average, paid less than they were forty years ago, despite vast increases in education, skill and productivity.<sup>2</sup> Over the last several decades, ordinary Americans struggled to overcome flat or declining pay, first, by working harder – the once standard one-income family giving way to two and sometimes more jobs, as Americans accepted the longest working hours of any advanced democracy.<sup>3</sup> When the one-income family reached near extinction and we could no longer maintain household incomes by working more, we began to go into debt, staving off the inevitable for a while longer.<sup>4</sup> But this too has run its course; the collapse of the housing bubble was, it seems, the last gasp of the debt-powered consumer.

Bad as declining wages for ordinary Americans are, the problem is actually worse. Economists used to assume that wages track productivity – competition ought to assure that employees are paid based on what they produce, so there is a certain rough fairness to the wage system. That link is broken. Productivity continues to increase, but our corporate system is sending its gains to a small and shrinking part of the population – not the producers, but the rentiers.<sup>5</sup>

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<sup>1</sup> Krugman/ FRED (Research.stlouisfed.org; Mishel, State of UW Working Class

<sup>2</sup> E.g., <http://scalar.usc.edu/works/growing-apart-a-political-history-of-american-inequality/mind-the-gap-the-dimension-of-american-inequality>. TAN 6. « Low- and middle-wage men and women lost ground across the last 40 years—a pattern interrupted only by the sustained growth, low unemployment, and minimum wage increases of the late 1990s.” Id. See also, Edward Wolff

<sup>3</sup> FRED (hours worked per employed person has bounced around but dropped dramatically in the 70's, almost returned to its peak in the 90s and declined even lower since 2000. However hours worked per household shows a different picture

<sup>4</sup> FRED; Who stole the American Dream

<sup>5</sup> Productivity has doubled since 1970, despite the famous slowdown in its growth. FRED: Real GDP per Hour Worked in the United States (USARGDPH). See, e.g., Robert Pollin, Back to Full Employment at 41, Figure 1 (showing productivity doubling since 1972, while real median hourly wages for non-supervisory workers have actually declined).

Inequality has soared, and the corporate sector has been a leader in the new Reverse Robin Hood regime. The bottom half of the country is falling behind, the middle is treading water, and meanwhile at the very top, rising pay, increased profits and decreased taxes for the very rich have allowed the best off to leave the rest of us behind.

The new inequality is morally and politically wrong: it defies the basic principles of common enterprise and common citizenship on which our society is founded. We are all partners in society, and presumptively ought to share in the proceeds of our common enterprise.

No republic can long stand, as the classical thinkers pointed out, if some citizens (or factions or, in our case, corporate enterprises) are so wealthy and others so desperate that the former can purchase the loyalty of the latter, turning citizens into hired mercenaries. But even from a narrow economic perspective, rising inequality is a serious problem, for much the same reason.<sup>6</sup> Our capitalist system is productive because it harnesses the work and effort of everyone, combining each of our contributions to create something that could not exist without us. It is just wrong for those at the top to seize a share of the joint product that reflects not their contribution but their power. Also, it doesn't work. As Acemoglu and Robinson recently reminded us, repeating an ancient theme, once an elite becomes sufficiently powerful, it often finds taking easier than making.<sup>7</sup> Taking a larger share of the national wealth just requires buying legislation and police power; growing the pie so that everyone benefits requires creativity, skill, work and willingness to share.

The great success of the United States once was that our upper class grew rich by making life better for all of us. The new inequality is moving us in a more common direction, where wealth is more likely to result from power and position than production, and the interests of those in charge of important institutions may diverge from those of the rest of us.<sup>8</sup> As the history of Latin America and too many other places demonstrates, a small elite can do just fine even as the rest suffer.<sup>9</sup> In the US today, we have structured our markets and the corporation enmeshed in them to create too many incentives for decision-makers to pursue financial maneuvers, monopoly power, or legal rules to embalm the results of long-ago efforts – massive wealth comes from position rather than production.<sup>10</sup>

Capitalist markets work by constant change: innovative products and production methods drive out the obsolete and inefficient, in the process Schumpeter called “creative destruction.”<sup>11</sup> But, of course, the wealthy will always seek to preserve their position against the constant churning of capitalist markets. As Adam Smith noted, “people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise

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<sup>6</sup> Stiglitz;

<sup>7</sup> Acemoglu and Robinson. Cf. Richard L. Hasen, Lobbying, Rent-Seeking, and the Constitution, 64 Stan. L. Rev. 191, 193-94 (2012)

<sup>8</sup> <http://opinionator.blogs.nytimes.com/2013/06/19/our-broken-social-contract/?src=me&ref=general> (charts showing rise of corporate profits, and break in linkage between productivity and wages; sharp increase in share of top 1% and rise in Gini)

<sup>9</sup> Acemoglu, supra.

<sup>10</sup> Dean Baker Loser Liberalism. The continual extension of copyright to keep Mickey Mouse covered, allowing the Disney Corporation to continue to profit from movies made long ago is a famous example. The extraordinary growth of finance industry profits, based mainly on sale of tools to evade law and risk regulations, is clearly a key part of our Great Recession. 13 Bankers. Monopoly grants allow pharmaceutical companies to charge prices thousands of times higher than the cost of production for essential goods, Dean Baker, in a self-inflicted imitation of the East India Company's profits from creating famine in Bengal. The Company that Changed the World.

<sup>11</sup> Schumpeter

prices.”<sup>12</sup> Unfortunately, current corporate law encourages corporate decision-makers to use the power of their office – and the institutions they run – in exactly this anti-social way. So we see successful businesses suppressing or delaying innovation, as when RCA closed down research on flat screen TVs to protect its existing franchise,<sup>13</sup> or Myriad sues to prevent competitors from using standard techniques to identify cancer genes.<sup>14</sup> They try to structure their businesses so as to lock in customers, hoping to create monopoly power and stifle new technologies, as the oil, coal and auto industries have long done, or seems to be the standard Silicone Valley business plan. Worse yet, they lobby for additional legal protection to protect themselves from market forces: ever longer copyright and more expansive patent monopolies, holding medical sector reform hostage to insurance company profits, transfer of government functions like jails, education or infrastructure to create private profit even at the cost of higher costs and lower quality, and so on. Or they seek implicit or explicit public subsidies of incumbents, as in the “too big to fail” banking sector, subsidized industrial food, or oil and coal production – often by creating special exemptions from the general obligation to clean up ones messes.

The more powerful the incumbents are, the more likely they are to succeed in escaping the market’s disrespect for the past. Increasingly, our democratic system seems captured by entrenched economic interests that refocus law making on further enriching the incumbent property-owners instead of pursuing the common welfare. We seem to be well on the way to a self-reinforcing cycle where economic inequality creates political influence that, in turn, reinforces and increases the ability of the economic elite to seize yet more of the economic pie even while undermining the very bases of mass prosperity.<sup>15</sup> The Supreme Court’s recent unleashing of yet more corporate influence in the Citizens United case is but one more step in a long march.

Third, inequality at the bottom destroys the customer base on which markets depend.<sup>16</sup> The limiting factor in most capitalist economies most of the time is demand: producers won’t produce unless they have customers who can and will buy. Historically, the United States built its prosperity on mass consumption: by paying ordinary people well, we created the customers necessary to make highly innovative research and ever more efficient production profitable. Today, however, we are increasingly trapped in a downward cycle. The minimum wage – which directly or indirectly determines the income of close to a third of Americans – is half of what it was in 1965 relative to productivity. Employees aren’t paid enough to buy what they make. If there are no customers, there is no reason to invest, and without investment, there is nothing from which to pay the employees who are also your customers.

Finally, markets, unless properly guided, tend to worsen these problems, in a downward cycle that threaten their very existence. The basic market principle is free bargaining under contract law: autonomous individuals reach mutually beneficial agreements to exchange, with the state intervening to enforce the agreements but not to set their terms. But anyone who was ever a child in an unsupervised schoolyard – or who read the story of Joseph in Egypt – knows what happens when the strong and weak

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<sup>12</sup> Adam Smith, *Wealth of Nations*, Ch X pt 2.

<sup>13</sup> Nicholson Baker, *A Fourth State of Matter*, *New Yorker* (July 8, 2013) at 65.

<sup>14</sup> <http://www.bloomberg.com/news/2013-07-09/myriad-genetics-sues-ambry-to-thwart-rival-cancer-test.html> (description); [http://patentdocs.typepad.com/files/university-of-utah-et-al-v-ambry---2\\_13cv00640-rjs.pdf](http://patentdocs.typepad.com/files/university-of-utah-et-al-v-ambry---2_13cv00640-rjs.pdf) (complaint).

<sup>16</sup> Keynes, *General Theory*.

make mutually beneficial agreements. As every self-help book in the business section advises, he who can walk will always get the best end of the bargain. Bullies win in the playground, because lunch money is always a fair deal for not getting punched.

And after Joseph filled Pharaoh's storehouses with the farmers' own grain to sell it back to them in the drought, he gathered "all the money that was in the land ... and when money failed ... all their cattle." In the second year, the farmers begged him, "buy us and our land for bread and we and our land will be servants to Pharaoh, and give us grain that we may live and not die, that the land be not desolate." (Gen 47: 14, 19). Voluntary serfdom or slavery, after all, is better than starving.

But markets that distribute all the profits upwards in this way self-destruct: after Joseph "bought all the land of Egypt for Pharaoh," the people no longer had anything to buy or sell. When the East India Company transformed a routine drought into the great Bengal Famine by buying up all the available grain and selling it for profit-maximizing prices, it transformed one of the richest economies of the world into utter poverty. Our own company towns in the dark days of the Robber Barons were little different. Indeed, even now, Walmart and too many other firms pay Americans too little to shop anywhere but Walmart, creating a recurring cycle of poverty instead of affluence. Henry Ford is said to have understood that paying his employees more would make them better customers, but modern corporations have forgotten that lesson. Markets, as we have organized them, tend to suppress demand, directing most of the gains to trade to those who already have the most and are therefore likely to buy the least.

The problems with corporate jobs go beyond stagnation and inequality. Our corporations no longer generate enough jobs to keep Americans employed, even at reduced pay. In the generation since the Volker recession, we've hit full employment only for a few years under Clinton – and even then, only by defining full employment at levels that would have been unacceptably low even to opponents of the Humphrey Hawkins Full Employment bill not so many years earlier. The private sector, it turns out, cannot produce full employment without active assistance from the government, but since the Reagan Revolution, both our political parties have recharacterized rising wages – prosperity – as, instead, inflation. For too many of our leaders, full employment – and the bargaining power it gives ordinary Americans – is therefore a great evil rather than the goal.

Moreover, too many of the employed hate their jobs.<sup>17</sup> Corporations should be able to use team spirit to outproduce markets – people are generally happier cooperating and working together than working alone or competing. But ours don't. Instead, we get all the ills of top-down planning and irresponsible bureaucrats – epitomized by the bosses and employees in Dilbert and the Simpsons – without the benefits of loyalty or collective action. To add injury to insult, it turns out that the hierarchal power structures of most corporations are bad for our physical health as well.<sup>18</sup> These are not the fulfilling jobs to which we aspired as kids.

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<sup>17</sup> <http://opinionator.blogs.nytimes.com/2013/06/20/checking-out/?hp> (citing Gallop poll indicating that 70% of employed Americans are disaffected and unproductive at work).

<sup>18</sup> Spirit Level; Marmot on Whitehall Study; Mind the Gap.

Not only is our corporate sector failing to produce the jobs we depend on for income and satisfaction, it fails to produce the goods and services we need.

Our infrastructure is said to be crumbling. Unfortunately, that metaphor sadly misses the relative backwardness of our mass transit and intercity trains, cheap internet, technical training systems, early-childhood support and other essentials of modern economies: they barely exist. A generation ago, we led the developed world in higher education; today that is only true at a tiny number of elite institutions. For ordinary people we lead, instead, in the percentage of the population that we incarcerate and on the sums we spend on prisons, often under the direct influence of private sector prison profiteers.

We are making even less progress towards the transition to the post-petroleum economy that nearly everyone acknowledges is essential. Instead, we seem to be giving away our leadership in environmental protection, as “deregulation” allows incumbent economic actors to extract short-term profit without regard to consequences to others or the future -- by dumping pollutants and global warming gases, exploit limited resources, or operating dangerous factories in the local with the least protections for its citizens. In Larry Mitchell’s evocative term, we’ve allowed our great corporations to become “externalization machines,” skilled in finding new and creative ways to force others to pick up their costs.

Similarly, our corporate-based, largely for-profit, medical care system is a disaster.<sup>19</sup> Drug companies used patent monopolies to charge prices far above costs of production and waste the resulting profits on marketing or searching for new monopolies. Hospitals and doctors succumb to powerful market incentives to overtreat, undercure, and pursue market power at the expense of professional quality. To pay for the extraordinary expense of market-based mismanagement, we rely heavily on employer-purchased private insurance. Since insurers make money by denying claims, they and providers create matching armies to battle over payments; the ensuing conflicts may add a third to our total costs without even considering the misery and time patients must invest. The net result is health statistics among the worst in the developed world –at twice the price of any other developed country.

But the future looks even worse. As private sector health insurance reaches its limits, out of pocket costs are rising even as overall medical costs begin to slow. Perhaps medical care will not bankrupt us collectively – but they remain a competitive drag on any American enterprise with foreign competitors, the most common reason for middle class families to financially collapse, and a budgetary threat to important institutions throughout the economy.

The corporate sector performs no better in other essential areas.

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<sup>19</sup>See, e.g., [http://jama.jamanetwork.com/article.aspx?articleID=1710486&utm\\_source=Silverchair%20Information%20Systems&utm\\_medium=email&utm\\_campaign=JAMA%3AOnlineFirst07%2F10%2F2013](http://jama.jamanetwork.com/article.aspx?articleID=1710486&utm_source=Silverchair%20Information%20Systems&utm_medium=email&utm_campaign=JAMA%3AOnlineFirst07%2F10%2F2013) (demonstrating that US has worse health statistics in almost every category than other rich countries, despite the vast expense of our corporatized health system); [http://www.digitalnewsrelease.com/?q=jama\\_3896](http://www.digitalnewsrelease.com/?q=jama_3896) (JAMA editorial summary of study); <http://www.economist.com/blogs/democracyinamerica/2013/07/disease-and-death-america> (summarizing above). See also, Marmot..., Wilkinson, Mind the Gap (presenting strong evidence that inequality worsens public health at every level of the status hierarchy).

Our system of financing education is, at best, dysfunctional: this central concern of middle class families is increasingly out of reach. At the other end of life, our corporate based pension system is inadequate in size and funding. The old defined benefit plans put companies at a competitive disadvantage relative to foreign corporations without this responsibility, and in any event, were tempting targets for financial manipulators. They were doomed once the global economy recovered from World War II, even had managers not learned how to raid them. The newer 401(k)/IRA defined contribution plan that have replaced them will turn out to have been a complete disaster. Contrary to the most fundamental rules of risk management, they shift the risk of both macroeconomic business cycles and individual investment decisions to those least able to diversify them away or plan appropriately. This makes them inherently more expensive than either the private plans they replaced or the far more efficient Social Security system – yet they've been funded at lower levels. Unless we rapidly increase Social Security payouts, the richest country in the world is likely to have shocking levels of poverty among the next generation of senior citizens.

Our military expenditures are as large as the rest of the world's combined, much of it run through the private, for-profit, corporate sector. Yet we lack the most elementary expertise about our enemies and the last administration's experiment in out-sourcing military tasks to the corporate sector generated far more corruption than security or reconstruction.

Advertising and its twin, lobbying, have sculpted our habits, our values and our law. Just to take one example, Marion Nestle has documented how the processed food industry has transformed our diet, not for the better, beginning with government subsidies for ecologically unsound farming to produce unhealthy food, corporate advertising and school lunch programs to change children's taste buds, and lobbying for regulation to permit unsubstantiated health claims while barring disclosure of egregious industry practices. The courts have cooperated, elevating corporate advertising to the level of the religious conscience, political debate and artistic creation protected by the First Amendment -- even finding that labeling milk to disclose whether it comes from cows fed hormones violates a purported First Amendment right of corporate producers to deceive their customers by silence. Advertising as a form of manipulating the population has been a concern to observers at least since Thorstein Veblen's Theory of the Leisure Class and the classic sociological studies of the 1950s.

Now, in the logical conclusion of the long trend of increasingly effective advertising manipulation, we seem to be in the process of delegating our electoral system to corporate advertising and corporate funding. Despite the promises of the Supreme Court, unlimited corporate funding for corporate aims in electoral politics is less likely to increase freedom than to multiply all the ills of the current system.

In short, government, business enterprises and markets as we have structured them today are not working to create and maintain sufficient well-paid and decent jobs for the less skilled 80% of the population, effective and cheap education and health care systems, well-maintained bridges, dikes and mass transit, reliable pensions, affordable urban housing, or – as the latest crisis makes clear – even a functioning banking system.

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Why focus on corporate law? Many of the problems we confront could be solved directly elsewhere.

- We know how to eliminate unemployment and end the recession: simply enact counter-cyclical investment programs that would generate Federal funding for vital infrastructure and research projects whenever the unemployment rate exceeds 5%. Reducing unemployment would profoundly increase the bargaining power of ordinary Americans, leading to better working conditions, more interesting jobs, and happier employees. Our economy is almost always demand constrained; by shifting income from corporate profits (where it is hoarded) to ordinary employees (who will spend it), we'd increase total demand and create incentives for employers to invest in increasing productivity – the result would be more jobs at better pay and increased economic growth.

- We must address global climate change. In a rational political system, we'd start by creating massive Federal programs to convert to non-carbon fuels with the same vigor we used to build the highways and suburbs, combined with a carbon fee to fund clean-up and transition expenses, market incentives for individuals and businesses to upgrade efficiency and install decentralized sustainable power, and building modern inter- and intracity mass transit worthy of the richest country in the world.<sup>20</sup> We did it to build the railroads, the suburbs and to reach the moon; we can do it to make our economy ecologically sustainable too.

- We could improve our health and solve the health care cost crisis with a one sentence statute: Every American shall be permitted to enroll in either Medicare or the VA system during an open enrollment period each November.

- The simplest way to deal with inequality at the bottom would be to double the minimum wage and then automatically increase it in line with productivity increases, while simultaneously At the top, a return to the progressive income tax rates of the 1950s while closing the loopholes that allow so much capital income to go untaxed would improve the entire incentive structure of the upper class while eliminating most of the full-employment deficit.

- If we shrunk our prisons to international levels, ended the failed war on drugs, dismantled the SWAT teams and disarmed paranoiacs and vigilantes, we'd have plenty of money to restore art to the public schools, fund the state university systems, eliminate student loans – and even increase the number of police on the beat, to reduce crime instead of punishing it.

There is no reason why we need to have a criminal justice system as violent and ineffective as Saudi Arabia's, medical statistics little better than Cuba's, or airports with lines and security imitating the unlamented Soviet Union.

These reforms need not start, or end, with corporate law. Yet corporate law is a major part of the reason why our political and economic system is failing to deal with them. Our political and economic system is dominated by giant business corporations—and we've lost control of them. We

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<sup>20</sup> Acemoglu and Richardson include a picture of an abandoned railway station in an African country as a symbol of the reversibility of economic progress. For an American audience, this is backwards. We know what abandoned railroads look like. They should, instead, have included some descriptions or pictures of what modern rail transit is like in countries that are not 75 years out of date.

used to think that consumer (or perhaps financial) markets, with some legal regulation around the edges, would guarantee that these institutions respond to our needs. Instead, our institutions have declared independence, pursuing a logic of their own that, too often, is not helpful. The political system that is supposed to guide the invisible hand is, instead, captured by incumbent economic power, so that no reform is politically viable unless it leaves in place all existing profit, no matter how anti-social. Health and financial sector reform must pass the veto authority of the insurance and finance companies that profit from the status quo; war and prison profiteers, not the national interest, determine our policies in the wars against drugs and terror; lobbies for low-value employers who profit only because they can force their employees to rely on public assistance or dump waste and risk on the general public demand, successfully, that we keep unemployment high, wages low and basic regulation unenforceable. Competitive sports are not improved by allowing teams to cheat (although the teams most able to cheat or most dependent it often disagree). Economies are no different. Fair competition leads to growth and prosperity. Cheating leads to – more cheating.

Today, it is clear that something has gone wrong with corporate law. Actually, many things have gone wrong. And many are easily fixable, if only we choose to fix them. No law of nature says that we must reward, or even tolerate, cheaters.

At the most fundamental level, the problem and solution are familiar. Our ancestors fought for many generations to establish the fundamental democratic principle that government is not the property of the Ruler, but instead exists to serve the People and must be responsive to popular needs and values. Now we need to extend these clear principles to our economic rulers. It is time to declare that corporations – not just governments – are created by us to serve us, not the other way around. Their leaders are public servants, not our private masters.

More concretely, we need to reorganize, or sometimes just tweak, many areas of corporate law to change the powers of their leaders and the expectations we have of them.

**First**, we have failed to take seriously the difficulties of running giant organizations. For at least a generation, corporate law scholars and reformers have assumed that the central problem of corporate governance is that corporate managers might betray shareholders. This happens. But the larger picture of the last generation is an alliance of the financial markets and top executives – the former has metastasized and the latter become extraordinarily wealthy, in both cases at the expense of ordinary Americans, economic growth and political sanity.

Our major corporations themselves are giant bureaucracies, answerable to a chief executive of whom we have seemingly superhuman expectations. Despite the sycophantic praises of the press, superhumans remain rare. As a result, apotheosis regularly fails.

Even as our corporate leaders increasingly emulate the later Roman emperors in their cults of personal worship, the institutions nominally under their control generally follow the instructions of impersonal and often random market forces. Corporate organizational charts grant the CEOs extraordinary power, yet they seem to have little ability to control the organizations they attempt to lead. Increasingly, they

divide into the brief-tenured, who move on or are fired before they can have much impact while their institutions suffer from long periods of leaderlessness, and the long-tenured, whose regimes far too often end in devastating scandal (often deferred until just after the great leader's retirement).

The leaders who last are those who give the financial markets what the market wants, not those who fight it. But the stock and bond markets fail to give the right instructions. Finance-responsive corporations too often make decisions that reduce, rather than enhance, our long term prospects for well-being.

Meanwhile, the managers who are supposed to run our great firms drown the sorrows of their powerlessness in increasingly heady drinks of unimaginable wealth. CEO prerogatives have become so rich as to rival the aristocracies of the Ancien Regime or the party nomenklatura of the unlamented USSR.

Just as in those failed systems, the gap between ruler and ruled has grown so wide that morale, decisionmaking, information flows and loyalty are increasingly problematic. Executives are not paid their monumental sums because they have "produced" them – no one could produce that much. On the contrary, like aristocrats of old or fortunately placed rentiers in every era, they take what they can. But their taking makes it harder to lead, and far harder to inspire those who do the actual work. In our corporate world, we no longer face, if we ever did, a tradeoff between efficiency and fairness: the main source of inefficiency is the indefensible lack of justice in the distribution of corporate gains.

Fortunately, we know how to ameliorate, if not eliminate, these problems. It's not news or mysterious that leaders are more effective when they are close to those they lead.

**Second**, despite the emphasis on "agency cost" analysis in corporate law, we have neglected the full extent of the ever-present threat of corruption: of the powerful using their power to seize more power, in both the economic and political spheres.

Capitalist creation at its best – uniting innovation with the efforts of many people in order to create a better life for all – is extraordinarily difficult. Moreover, as commentators from Marx to Schumpeter have noticed, it is always unstable: competitive markets have no respect for the past. As newcomers to a market produce new or improved services or products, they threaten the established powers that be. In a market that functions the way we hope markets work, all power and success is ephemeral.<sup>21</sup> A company that produces a better or cheaper product will win enormous rewards as customers flock to it – but its very success will attract competitors, who will quickly adopt or surpass the innovations and drive prices and profits down.

Unfortunately, existing corporations and their managers will always find it easier and more profitable to use their existing power to build still more power. Creation is difficult, but lobbying for laws that favor

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<sup>21</sup> This instability is a key part of the ordinary defense of "equality of opportunity" or social mobility as a replacement for the equal citizenship and equal protection of the laws that egalitarians traditionally sought. One of the several problems with the equality of opportunity concept is that it requires background equality – otherwise, the privileged will have the tools to pass their privileges on to their children, and the equal opportunity will be, at best, a myth. The US is currently one of the least equal of the developed countries – and, not coincidentally, has unusually low social mobility.

incumbents is neither intellectually taxing nor expensive – no innovation is required to draft laws granting patent monopolies, allowing businesses to pollute or create risks without remedy, privatizing governmental functions, or capturing captive customers (literally, in the case of the prison-industrial complex). Threatening to fund attack ads against politicians who suggest reform is cheaper and easier still – especially if the threat is backed up by enough money to make it so credible it never needs to be carried out.

Similarly, in the short term, any company can generate tremendous profits by mining its reputation – using it up rather than maintaining it for the long run. Building and maintaining a reputation for service, quality or innovation is expensive and risky. But deception is cheap. Consumers are conservative and it is usually easy to fool them for a while. In the short term, cutting back R&D or service or quality controls saves large expenses – and if consumers don't notice immediately or have no ready alternative at hand, sales will not drop commensurately. To be sure, eventually consumers will figure out what is going on, but that is a long term problem; managers or shareholders with quick exit plans may be long gone before the damage to the company becomes obvious.

Once this game has become well understood, as it has in the last few decades, even those who'd rather avoid it may be forced to play. If customers learn that reputations are made to be destroyed, they may stop trusting them. If they also cannot readily establish quality before purchasing, they may simply refuse to pay for quality that they can't be sure they are getting. This is Akerloff's market for lemons.<sup>22</sup> Left to its own, it will force even companies that would prefer to produce a better, but more expensive, product, to join the short term game.

Extraction and redistribution are also often easy. Making the pie larger requires innovation and creativity and skill, but top executive or investors need no more than a strong arm and a weak conscience to get rich by cutting tiny amounts from each slice of a large numbers of average citizens, and then taking all the crumbs for themselves.<sup>23</sup> With the right framing, companies may find that they can convince employees to work harder for less pay: usually all it takes is borrowing enough money or diverting enough R&D, to be able to say that times are desperate and the company will fail or jobs will be lost if employees don't pitch in.

Similar framing may help them convince regulators to allow corporations to take risks without insuring or setting aside reserves to pay for the inevitable failures, or to win bailouts or subsidies or tax cuts to cover costs of business that, in an ideal capitalist market, they'd have to pay. Why engineer a more efficient production process if you can, instead, convince regulators or politicians that dumping your garbage on the public's space is free or that global warming is merely a plot to reduce your profits? A tiny skim from many salaries, many products, many taxpayers can often pay for a significant increase to

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<sup>22</sup> George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 (3) Q. J. ECON. 488 (1970).

<sup>23</sup> The Supreme Court has made this easier with a line of cases limiting class actions and punitive damages, usually the only practical legal enforcement mechanism to remedy these types of wrongs. See, e.g., *State Farm v. Campbell*, 538 U.S. 408 (2003) (limiting punitive damages even when evidence indicates that large award is necessary to deter future wrongdoing); *American Express Co. v. Italian Colors Restaurant*, No. 12-133 (June 20, 2013) (holding that arbitration clause precludes class action that was only practical procedure to pursue claim). Similarly, its sanctification of arbitration clauses means that powerful players can set both the terms of a contract and the forum in which it will be litigated, effectively precluding any possibility that the law will step in to protect those who lack market power to protect themselves.

a small group of top executives or investors. Instead of pursuing the difficult tasks of creating new wealth, our corporate leaders have instead taken the easier route of corrupting our political system.

In our democratic capitalist economy, we depend on government to guide the market, to set the rules that make productive activity profitable and mere theft or exploitation not. But increasingly, markets control government rather than the other way around. Major corporations, seeking to increase their profits, discover that the easiest way to do so is to buy law and regulation that allow them to suppress competition, create monopoly power, shift their costs to employees, customers, the taxpayers or the environment as a whole, or exploit human cognitive failure (if not simple fraud and deception) to sell their products. One example regularly in the headlines is the farm price support and insurance program, which pays agribusiness to produce the industrial foods that are major causes of our obesity and diabetes epidemic while doing nothing to encourage sound farming practices. And is designed – seemingly intentionally – to make fraud nearly impossible to prevent.<sup>24</sup>

The result has been slower growth. But even more dramatically, the benefits of growth over the last generation have gone almost exclusively to the very top of the income distribution – the top 1% and especially even higher. The increased inequality that followed has made each of our problems worse: reducing demand and making it more cyclical, reducing the responsiveness of both market and politics to ordinary people, making Reverse Robin Hood policies more attractive to the powerful than Rising Tides Raise All Ships.

Less visibly but just as important, our misplaced distortion of the price system harnesses human ingenuity and the power of the markets to destroy, rather than enhance, our environment. Pollution is a cost of production – in this era of global climate change, where our use of carbon-based fuels threatens to cause a vicious cycle of accelerating warming as the permafrost releases even greater quantities of methane and carbon dioxide, perhaps the most important cost of production of all. In a true competitive market, producers who use collective resources – especially those essential for our collective survival – must pay for them. So long as we price pollution and greenhouse gas emissions at zero, however, no profit-seeking firm has any incentive to reduce them. It's not possible to make a profit selling or saving something with no price. And our corporations are responding, predictably, to the incentives we've created for them: blithely continuing to soil our nest, while protecting their profits by using their political power to defend their legal right to make messes without cleaning up.

Today, we stand at the edge of mass extinctions and climate change not seen in recorded human history. Instead of using the profit motive, capitalist markets and corporate organizations to solve this greatest of our challenges, we are doing the reverse.

**Third**, we – and especially the Supreme Court – have ignored George Orwell's important lesson about manipulating public opinion.

Neither law nor regulation is for sale, strictly speaking. But the advertising industry has taught all major economic players how to manipulate public opinion. To oversimplify a bit, opinion-makers *are* for sale,

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<sup>24</sup> See, e.g., [http://www.nytimes.com/2013/06/18/us/politics/fraud-used-to-frame-farm-bill-debate.html?\\_r=0](http://www.nytimes.com/2013/06/18/us/politics/fraud-used-to-frame-farm-bill-debate.html?_r=0).

more or less crudely. So too are the Institutes, media networks and similar platforms that make them seem authoritative.

Science and politics alike work largely by consensus of the authorities: no one has time or mental capacity to investigate most claims, so we each rely on the assumption that most of the time, the consensus on issues where we lack expertise is more or less correct. If it were wrong, we presume, those operating in reliance on it would discover problems or anomalies and, eventually, word would filter through to the rest of us.<sup>25</sup> When science and public opinion are working as we hope, positions that make sense and fit together with other people's knowledge get repeated and amplified, while those that fail to explain the world or make useful predictions tend to disappear.

But the process is imperfect at best – and easily distorted. With enough money, an appearance of consensus (or even more easily, dissensus) can be created with no connection to underlying reality. Opinions can be made to seem to be mainstream by repetition, even if the only people who repeat them are paid to do so. (In reality, this is rarely necessary. People hold many and diverse opinions; funders can simply fund the views that they find useful, amplifying them by a process of artificial selection. Once it is clear which voices get heard (and who gets paid), ordinary processes of cognitive dissonance assure that a reliable percentage of spokespeople will believe what they say. As Upton Sinclair said, "It is difficult to get a man to understand something, when his salary depends upon his not understanding it."<sup>26</sup> On the other hand, it is striking how often prominent proponents of deregulation and other forms of abuse change their minds when they leave the jobs that made them rich – for example, Sanford Weil, the architect of the original too-big-to-fail financial conglomerate, Citicorp, now thinks that he shouldn't have been allowed to do what he did.<sup>27</sup>)

When Groucho Marx asked his mark, "who are you going to believe, me or your lying eyes," he was merely repeating the basic maxim of the advertising industry. Advertisers and stock traders have long understood the concept of the "informational cascade" in which people, herd like, follow opinions of others without regard to whether they are true.<sup>28</sup> Stanley Milgram's famous obedience experiments, in which subjects followed orders from apparent authority to torture strangers, have been repeatedly amplified. People are hard wired, and reasonably so, to doubt their own judgment when presented

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<sup>25</sup> "Somewhere or other – I think it is in the preface to *Saint Joan* – Bernard Shaw remarks that we are more gullible and superstitious today than we were in the Middle Ages, and as an example of modern credulity he cites the widespread belief that the earth is round. The average man, says Shaw, can advance not a single reason for thinking that the earth is round. He merely swallows this theory because there is something about it that appeals to the twentieth-century mentality." George Orwell, *As I Please*, Tribune, Dec 27, 1946. The actual passage is "In the Middle Ages people believed that the earth was flat, for which they had at least the evidence of their senses: we believe it to be round, not because as many as one percent of us could give the physical reasons for so quaint a belief, but because modern science has convinced us that nothing that is obvious is true. ... Not for worlds would I question the ... existence of electrons (whatever they may be). The fate of Joan is a warning to me against such heresy." Preface to *St Joan*, at 1026. Orwell's version improves on Shaw's by pointing out that for most of us, most of the time, most of what we know we must accept on authority – but we accept the authority because it appears to fit in a coherent whole. The authoritative statement of the earth's roundness is persuasive because we also believe, also on authority, that airplane pilots and GPS satellites rely on it; to reject one part of the authoritative structure seems to require rejecting too much else as well.

<sup>26</sup> Upton Sinclair, *I, Candidate for Governor: And How I Got Licked* (1935), repr. University of California Press, 1994, p. 109.

<sup>27</sup> "Even Sandy Weil, former CEO of Citigroup who led the charge against the remnants of Glass-Steagall in the 1990s, concedes that this was a regrettable mistake – and argues for all of the biggest banks to be broken up." [http://baselinescenario.com/2013/07/14/remember-citigroup/?utm\\_source=feedburner&utm\\_medium=feed&utm\\_campaign=Feed%3A+BaselineScenario+%28The+Baseline+Scenario%29](http://baselinescenario.com/2013/07/14/remember-citigroup/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+BaselineScenario+%28The+Baseline+Scenario%29)

<sup>28</sup> The literature on rational informational cascades, also described as rational herd behavior, is huge. See, e.g., Bikhchandani, S., Hirshleifer, D., and Welch, I. (1992), "A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades," *Journal of Political Economy*, Volume 100, Issue 5, pp. pp. 992-1026. For a clear popular explanation, see, *Yes Ten Million People Can Be Wrong*, THE ECONOMIST 81 (February 19, 1994).

with apparent consensus to the contrary. After a century of work, the advertisers can often produce that appearance of consensus and authority, *ex nihilo*.

Even more reliably, actual consensus can be subverted for extraordinary periods of time. Consider, for example, the success of the smoking industry in creating an appearance of scientific controversy long after there was none, in convincing large numbers of people that its addictive product was a sexy, rebellious symbol of freedom, convincing jurors that personal responsibility applies only to the users -- not the sellers--of dangerous products, and, most recently, in inventing new legal theories, based in sources as diverse as the freedom of speech and Federalism, to win in the courts what it occasionally loses in the legislatures.<sup>29</sup>

The same lessons of the effectiveness of advertising, together with the Supreme Court's consistent and anti-republican use of the First Amendment to overturn fair campaign legislation, have made political campaigns increasingly expensive. Consequently, politicians must respond to the concerns of their contributors and – even worse – implicit and explicit threats of non-contributors to support others. Regulatory work is no longer particularly highly respected and the gap between government and private sector pay continues to grow, so many regulators view their government job as a stepping stone to more lucrative or prestigious work with the regulated industry. If politicians depend on contributions and regulators hope to land their next job with those they regulate, past market success can give corporations the power to suppress market change. Buggy whip manufacturers were swept away by horseless carriages. Nuclear power plants, on the other hand, simply won exemptions from ordinary tort law, while fossil fuel companies benefit from an entire ecosystem of rules, regulations, subsidies and planning decisions that force Americans to provide drivers with free parking, free roads, cheap fuel, and car-oriented zoning, while denying the growing numbers who'd prefer more liveable and efficient walkable cities the mass transit they need.

Political and scientific debate –like market economies generally – depend on the assumption that participants are generally acting in good faith.<sup>30</sup> Even a small number of people who refuse to follow conventional norms can destroy the trust that underpins the system. In the economy at large, if, for example, people begin to suspect that milk might, instead, be water mixed with melamine, those who are paying attention will refuse to buy (and those who respect them may as well). Worse still, honest milk producers may find that dishonest ones have a competitive advantage: in moderately competitive market including consumers who are willing to pay milk prices for melamine-water, the price of milk will quickly decline to that of melamine, driving honest producers out of business in a classic instance of

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<sup>29</sup> [Add in re history of smoking and health. Per Wikipedia, James I called it unhealthy; published statistics date to 1929. Per the litigation, companies were aware of cancer link by 1920s (presumably that is why they were advertising it as healthy). Lawsuit asserting that NY anti-smoking advertising violates Supremacy Clause (22-34 94<sup>th</sup> Street Grocery et al, v. NYC, SDNY 2010, despite the name includes all major cigarette manufacturers) seeks to prevent anti-smoking ads, while lawsuits asserting First Amendment right to promote addictive drugs seeks to ensure continuing pro-smoking ads (Commonwealth Brands v USA, WDKentucky (asserting a constitutional right to profit from “trademarks” and other “property” relating to corporations’ dangerous and anti-social activities in terms almost precisely parallel to arguments in Lochner). The Supreme Court has been quite sympathetic to claims that the Constitution protects corporate manufacturers against popular attempts to regulate their anti-social activities, despite the lack of any textual, structural or theoretical basis for this limitation of democratic rights of self-governance. E.g., *Lochner*, *Lorillard*, *Citizens Union*.]

<sup>30</sup> Eg. Francis Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (1996); Russell Hardin, *Trust* (2006); Schelling (1960?); Putnam, *Bowling Alone*; Stiglitz?

Akerlof's market for lemons.<sup>31</sup> Similarly, if they conclude that scientists or politicians are on the take or that businesses view their customers as marks to be rooked, they will turn to other sources of authority for guidance.

Even seemingly objective science has become increasingly corrupted by corporate money: the simple fact that work that promises to promote corporate interests is easier to fund exerts an inevitable evolutionary pressure on our collective body of knowledge. Political debate is often – though far less than our press seems to assume – less tied to verifiable fact and falsifiable theories.<sup>32</sup> Nonetheless, both empirical reality and theoretical cogency are vital to the continued function of our political system and the economy that depends on it. When politicians, regulators and courts are protecting the interests of incumbent economic powers, they necessarily destroy the dynamism that is capitalism's key strength.<sup>33</sup>

The corporate system, then, threatens to fail internally, while simultaneously corrupting government and market – the two countervailing forces we depend on to limit it.

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All is not lost, however. The mismanagement of our major corporations is not the result of some law of nature or intrinsic property of capitalism that we must accept as a price of prosperity or civilization. The detrimental effect on our politics is no more inevitable. Instead, by applying well-understood principles of traditional American political theory – democracy, checks and balances, limits on power, respect for fundamental rights, pluralism and division of powers, dedication to the public good – we could demand relatively minor reforms that would have transformative effects. We could, that is, combine economic growth with greater prosperity for ordinary people, more respect for the global ecosystem on which we depend, governments more responsive to the needs and desires of their constituents, and better jobs. Utopia, no doubt, is impossible. But we know how to take a big step in the right direction. All that is needed is a political movement to create political will.

While the symptoms of corporate failure are complex and multi-faceted, the underlying causes are relatively simple. Our economy, and for many of us, our working lives, are dominated by giant institutions organized as business corporations. But the law of business corporations ignores three centuries of American tradition of self-government. Instead of being modeled on democratic or free market principles, instead of respecting collective self-determination and individual freedom, corporate law reflects older, failed, ideas of plutocracy—rule by wealth—and absolutism—rule without checks and balances.

In the corporate world, we've been taught, falsely, that effectiveness, efficiency, and innovation require abandoning justice and autonomy: the price of prosperity is taking orders from the boss. In the public

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<sup>31</sup> George Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", *Quarterly Journal of Economics* (1970). Akerlof's own article is an example of the power of consensus in scientific advance: an outlier when written, it was rejected several times before becoming the basis of Akerlof's Nobel prize.

<sup>32</sup> Popper, Scientific truth article.

<sup>33</sup> Stiglitz, creative destruction

sector, we long ago discovered democracy is *both* more just *and* more effective than unrestrained rule by the self-appointed or most powerful. It is time to apply those lessons to the corporate sector as well.

In the following sections, I proceed as follows.

**First**, I explain the internal workings of current corporate law. Our law encourages – although it rarely mandates – corporations to be set up so as to give the most powerful the most power. Thus it concentrates already concentrated power even further.

This concentration of power has two ill effects: first, it increases inequality of both power and (since in recent years the corporate powers-that-be have used their power largely for direct material enrichment) wealth, which is bad in itself and because of its cascading effects on human health, flourishing, ecological sustainability, and economic well-being.<sup>34</sup> Second, for reasons that will be familiar to students of political theory, highly concentrated power at the top, especially when accompanied – as it nearly always will be—by disaffection lower down, leads to bad internal decision-making. Not only does too much of the pie go to a tiny elite, but the pie itself is smaller than need be.

These general problems are worsened by the structure of our corporate law. Our market system is regulated by two fundamentally different spheres of common law: on the one hand, the impersonal, formally equal, law of contract, and on the other, the highly personalized, structurally unequal law of agency and fiduciary duty.<sup>35</sup> Roughly speaking, contract law governs the relations between strangers or market competitors – it is the invisible hand that keeps the egoistic, self-interested profit maximizers of market theory working towards the common good and not degenerating into a war of all against all.<sup>36</sup> Agency law, on the other hand, is the set of rules that apply to armies, teammates, patriots, family and other compatriots in a common cause, in which individuals are expected see themselves as part of a whole greater than themselves, their team’s success as their own, and – usually – to accept and internalize orders from superiors. Adam Smith’s pin factory, exemplifying the division of labor, functions internally by top-down coordination and teamwork, not the competitive marketplace and bargaining among equals.

~~Corporations exist, as Ronald Coase pointed out, largely because they succeed where markets do not. Otherwise, Adam Smith would have been correct in predicting that joint stock companies could never successfully compete with people working for themselves. The main source of corporate success is that,~~

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<sup>34</sup> (Power corrupts, and our large corporations are no exception. Although this is hardly the largest of our problems, apparently as many as 80% of our major corporations may be tax avoiders: <http://online.wsj.com/article/SB123215048618892071.html?mod=testMod> (reporting that 83 of the largest 100 corporations had subsidiaries in tax havens). While using tax havens to avoid taxes is usually legal, it is never patriotic. In any event, the line is thin between extreme versions of tax avoidance, such as creating a subsidiary to avoid taxes, and illegal tax evasion – which includes organizational changes without economic substance made in order to avoid taxes – and often breached. Apparently, patriotism, willingness to bear a fair share of the common burden and simple law abidingness, are not characteristic of our largest institutions.)

<sup>35</sup> On fiduciary duties, see, TAMAR FRANKEL, *FIDUCIARY LAW* (Oxford 2007).

<sup>36</sup> Contract law is often understood as “consensual,” see, e.g., EASTERBROOK & FISCHHELL; HERBERT SPENCER, *SOCIAL STATICS*; Nozick [consent article]. The underlying notion of consent, however, closely resembles the “majestic equality of the law” in Anatole France’s aphorism: it “forbids rich and poor alike from sleeping under the bridges.” Consent takes on something other than the ordinary meaning when one party faces dire consequences and the other has all the options. Compare, Jean ValJean; POLYANI (describing threat of starvation as the essential historical first step in creating labor market). When contract law is more decent, it is primarily concerned with when consent is sufficiently meaningful to be enforced, and what norms to impose when, as is usually the case, there is no actual agreement. GRANT GILMORE, *DEATH OF CONTRACT*.

~~inside the firm, they reject markets: instead of coordinating by market pricing, they plan, and instead of motivating people by dreams of entrepreneurial wealth from fleeting market imbalances, they rely on teamwork and loyalty. This is not to say that planning and teamwork consistently beat markets—just that sometimes they do, and that’s where corporations prosper.~~

The key to understanding corporate law is that our law nearly always allows planners to decide where to place the line between agency and contract law. Planners, that is, can opt to plan and work in teams, using agency law – or to defer to the market and its contract norms of arms length competition.

Within the corporation, the basic law is agency: employees are agents of the corporation, who must, therefore, take orders from their superiors, act in the interests of the firm itself, and set aside their own personal interests. Like team members, partners or patriots, they are expected to consider collective interests as more important than their personal desires. The moral ideal is the Three Musketeers – all for one and one for all.

Outside the corporation, the basic law is contract: Every man for himself, and the devil take the hindmost. Obligations come from agreements, not from comradeship; the basic norms are those of strangers, not friends. In this legal world, arms length fair dealing is the most that is required.

Corporate planners may decide when to use fiduciary relationships and when to use contract relationships. Thus, for example, investors can be classified as equity, a fundamentally fiduciary relationship, or as creditors, with a fundamentally contractual relationship. Similarly, they may bring suppliers, customers or workers into the company, directing them by command and control and fiduciary relationships, or if they believe that market-based, arms length rules will produce better results, they may spin off or out-source that part of the enterprise. Often they may use both simultaneously, or alternately; individuals may sometimes be in one role and sometimes the other or even in an ambiguous intermediate state.

This fundamental ambiguity leads to interesting and sometimes disturbing results. Corporate law is a team sport in which many players, and particularly the head of the team, have the right to decide who is a member of the team and who is an opponent. Indeed, top managers may change their minds at any time, making that former team members into opponents. They don’t even need to be consistent – they are free to treat employees or supplier or customer as members of their team for some purposes and opponents for others. The same managers who say that employees are our most important resource are free to have mass layoffs or squeeze pay whenever that seems useful; a company that makes its living by convincing customers that it is on their side, is also permitted to turn around and exploit their gullibility.

Most firms can only succeed if managers can persuade employees to act like team members, voluntarily pitching in for the collective cause. That team spirit is what makes the firm more profitable than a market, despite the inevitable bureaucratic inefficiencies of the organization.<sup>37</sup>

But corporate law invites managers – themselves employees – simultaneously to view their team as the shareholders. Shareholders and employees have opposed interests when time comes to divide corporate proceeds: the more the employees get, the less the shareholders do. As representatives of the shareholders, managers are supposed to treat employees as a cost (as reflected in conventional accounting) and a mere tool to corporate ends, not as team members. They must, therefore, be prepared to betray them at any moment. In short, corporate law and practice teaches managers to play a double game.

This understanding of the corporation, which I think is absolutely conventional in every respect except the words, necessarily makes successful managers into extraordinary cynics –they are a form of double agent, creating an appearance of a team specifically in order to violate the basic morality of the team.

This is bad enough. People, after all, are reasonably good at discovering scam artists, and generally quite resentful and angry when they realize they've been scammed; it is hard to believe that corporate structures based on creating the appearance of loyalty without the substance will, over the long term, continue to command the loyalty of the deceived. The natural endpoint, instead, is for employees to reciprocate the cynicism, creating the appearance of loyalty while in reality simply looking out for number one and waiting for the moment when betrayal will be profitable.

The problem is compounded, however, by the demand that managers simultaneously act as fiduciaries towards the firm and its shareholders. In their real human relations with the actual people with whom they work every day, we expect managers to be cynics: pretending loyalty to employees and customers, but themselves ready to betray at any moment when cost-benefit analysis suggests profit from taking advantage of the other's gullibility. Then, we expect them to become saints with no thought of self, turning over their ill-gotten gains to the stock market – an abstraction with no human claims.

It is, in short, not surprising that managers fail. We've asked our managers to be, simultaneously cynics and saints, all powerful masters of the humans around them and abject and willing slaves to impersonal (and often powerless) abstractions. We ask them to be willing to sacrifice all relationships and all values to the idol of profit, but then to be motivated solely by loyalty in handing that profit on to others.

As a picture of how corporate managers should, or will, act, this is even less plausible than the old theories of an absolute monarch exercising God-granted and illimitable power only for the good of the people as a whole. It is not a stable system and it will not last. Absent reform, we should expect, instead, terminal cynicism. Employees and customers will learn, slowly or not so slowly, that they can expect no loyalty from the firm and therefore should betray it first if they get the chance. Control by

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<sup>37</sup> Coase, *Nature of the Firm* (1937); OLIVER WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM; Oliver Williamson, *Nobel Prize lecture*: [www.nobelprize.org/nobel\\_prizes/economic-sciences/laureates/2009/williamson\\_lecture.pdf](http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2009/williamson_lecture.pdf).

exit, without voice or loyalty,<sup>38</sup> is likely to lead to a truly Darwinian institutional slaughter – but, just as in natural selection, with no reason to believe that the survivors will be “fit” in any sense other than they will have survived, until they don’t. Institutions will suffer from endemic corruption from top to bottom as individuals put their own personal interests ahead of the collective’s.

Adam Smith viewed corporations as doomed to failure; for a century we have proven him wrong, but this road seems inevitably to lead directly to his dystopic vision of firms expert only at exploiting, not producing.

And the basic problems of divided loyalty and corruption compound other problems of the modern mega-corporation. First, the tension between the human need for structural stability and the market’s ahistoric disregard of all past claims, and second, the extraordinary information and competence problems involved in the modern mega-corporation .

Viewing the firm through a political lens clarifies the nature of the problem. Corporations are far more similar to armies and bureaucracies than they are to naked markets. At least since Tolstoy’s *War and Peace*, not to mention the extensive mid-century studies of bureaucratic failure epitomized, perhaps, by Halberstam’s *Best and the Brightest*, we’ve known the difficulties of implementing bureaucratic command and control structures. Leaders who, following Michel’s Iron Law of Oligarchy, rarely represent their followers, issue orders based on misinformation they think they’ve received from those lower down, who, in turn, struggle to ignore orders that make little sense in the actual situation confronting them. Failures of communication, just as much as the more outrageous corruption we call “self-interest,” necessarily plague our organizations.

Huge, centrally planned, enterprises would be difficult to manage under the best of circumstances. When the people doing the work, who have actual information and are responsible for actually implementing orders from headquarters, realize that their leaders are not actually on their side, inefficiency and failure seem inevitable. Suspicion and self-protection layer on top of the ordinary problems of collective decisionmaking, cognitive overload and hierarchal failure. To this we must add the tension between the market’s relentless disregard of the past and settled expectations, on the one hand, and the ordinary human need for stability on the other. People live lives enmeshed in particularity: it takes time to create a community; children are best raised in a single school; friends and relatives live in one place and not others; we rapidly develop skills when we are young but become less flexible and less interested in changing our profession or other aspects of life as we get older.<sup>39</sup> Corporate organization can provide – or pretend to provide – continents of stability amidst the shifting seas of the markets. But that stability can also become self-perpetuating rigidity in the face of a

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<sup>38</sup> Albert O. Hirschman

<sup>39</sup> See, e.g., Karl Polanyi, *The Great Transformation* 154 (describing the “painful loss of status which inevitably accompanies transference to a job at which a man is less skilled and which is not his own” and contending that most social resistance to markets is based on these cultural grounds rather than purely economic ones. See also, *id.* at 163 (“In practice [the rise of a market for labor] meant that the noncontractual organizations of kinship, neighborhood, profession, and creed were to be liquidated, since they claimed the allegiance of the individual and thus restrained his freedom”) 176 (agreeing with Mises that the labor market requires that workers be willing to “change[] their locations and occupation according to the requirements of the labor market” but pointing out that this “implied [intolerable]... extreme instability of earnings, utter absence of professional standards, abject readiness to be shoved and pushed about indiscriminately, complete dependence on the whims of the market.”)

changing world. Americans discovered that their big three automobile companies had quality, safety and pollution issues in the 1960s; the companies' executives, however, resisted change for a full generation before driving their institutions to collapse, Soviet Union style, in the post-housing bubble financial crisis. Less politically connected firms less embedded in the structure of American culture and economy have failed for similar reasons quite a bit more quickly: executives at Xerox, Kodak, Sears, Woolworths, and, perhaps HP failed to make obvious adjustments to a changing world.

**In Part II**, I explore the effects of our highly concentrated corporate power on our democracy as a whole. The powerful often use their power to accumulate more power.<sup>40</sup> In our case, our governmental bureaucracies and even the elected politicians themselves are highly subject to capture – and, as suggested by Schattschneider and Olson, the highly concentrated, highly organized corporate sector should be in the best situation of all to capture its regulators.<sup>41</sup> The unfortunate result is that corporate lobbying and corporate influence on the political debate have an inordinate effect on political decisionmaking.<sup>42</sup> Too often this results in regulatory regimes that simply allow the corporate incumbents to consolidate their power and increase their share of the economy – until the inevitable overreaching leads to crisis and collapse.

In the end, a modern economy and democratic politics each require a broad, financially successful middle class. When the middle class loses political power, the upper classes take too much of the economic gains; when economic gains go too heavily to a tiny upper class, insufficient demand eventually – now – leads to economic crisis. For three decades we staved off the inevitable crisis by, first, sending mothers to work, and then by borrowing. But both those processes have reached an end. Further economic growth requires a new “Fordism”: that ordinary people be able to purchase the products they produce.

Prosperity requires that we shift income downward to the middle classes. We need institutional changes – central banks that manage the value of the dollar so as to make middle class jobs competitive with foreign countries rather than to maximize bankers' bonuses; countervailing powers in our corporations and outside them to ensure that interests other than those of capital are represented in corporate decisionmaking and in the political processes; new ways of funding campaigns to give politicians some freedom to consider the interests of voters instead of donors; perhaps new ways of funding the press to ensure that real analysis and not just ideological claptrap reaches the mass media;

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<sup>40</sup> Stigler, G. 1971. The theory of economic regulation. *Bell J. Econ. Man. Sci.* 2:3-21; Hanson & Kysar, Taking Behavioralism Seriously III. Stigler's work, which presents itself as a revision of a (non-existent) previous view that regulation was well-intentioned, effective and free of external influence, is, of course, a central part of the delegitimization of the real project of government. It is somewhat difficult to believe that any serious political thinker has ever thought that regulators could be either entirely objective or free from external influence. Stigler's innovation is neither in his cynical and unrealistic view of the motivations of administrators – that view owes its origin simply to the bastard child of Machiavelli's Prince and the deepest Calvinist fears of unredeemed mankind, married to a narrow Benthamism stripped of its optimism, and its routine (if not consistent) in most neo-classical economics. Nor is it in pointing out that the powerful attempt to use their power via government and not just in opposition to it, an insight fundamental to every discussion of corruption in the Western political tradition. Instead, his importance is centrally political: in the “realist” claim derived from his work that nothing but self-serving influence peddling could possibly motivate government officials. In Hanson's terms, Stigler converted the classic observation of political thinkers – omnipresent in Western political thought since at least Moses and Plato – that all successful governments must have mechanisms to restrain corruption into a “motivational” claim that government officials are all evil. That, of course, threatens to become a self-fulfilling prophecy; decent people motivated by the public good or their understanding of it do not pursue careers in *baksheesh* and influence peddling.

<sup>41</sup> E.E. Schattschneider, *Semi-Sovereign People* (1960); Mancur Olson, *The Logic of Collective Action* (1971).

<sup>42</sup> Unnoticed, yet constantly noticed. See, e.g., Hanson & Yosifon, *The Situation*, text at n. 252 (discussing Galbraith's exploration of invisibility of corporate power over government).

taxation that is designed to make the richest Americans pay their fair share and regulation designed to ensure that successful corporations succeed by selling useful products at fair prices and not by extracting subsidies or avoiding responsibility for the collateral damage they cause. Market capitalism can make us rich again – but only if markets are structured so that profit comes from services rendered and not just scams implemented and subsidies seized.

Simultaneously, physical survival demands that we take immediate and drastic action to reduce our carbon footprint. The existing corporate system will have trouble doing this, because it is, ultimately, answerable to a stock market that has no way of valuing unmonetizable values, even life itself. Moreover, long term problems are poorly dealt with by a stock market that nearly always behaves as if it has an extremely high discount rate.

Capitalism and democracy alike requires that we shift income and power downwards. The more our system approaches “law for sale” or “elections for sale,” the more existing economic incumbents are able to use past economic success to buy future power and wealth. The key benefit of markets – the reason why we put up with their instability and inhumanity – is that, when properly run, they do not respect past success: they reward those who are producing needed products and services right now. Democracy works the same way: just because you won the last election does not mean you have a special lock on the next one. Or at least it shouldn’t. If our current elites are allowed to entrench themselves, to use the accumulated wealth of last generation’s technological success to squelch the next generation, we will quickly lose the dynamism of both sectors. Stable elites will always find it easier to shift income upwards than to grow the economy.

**In Part III**, I propose philosophic and concrete legal reforms. Others have written eloquently on the need to revitalize the governmental sector;<sup>43</sup> my concern here is with the twenty to thirty percent of our economy dominated by large, bureaucratic, for-profit corporations.<sup>44</sup>

After a generation of sloganeers chanting “government bad, market good,” it is time to recognize that this is a false dichotomy. Markets, at least ones that are more attractive than the kidnappings-for-sale of civil-war era Beirut, exist only by grace of good government, and the results they generate are a function of the rules governments impose (or fail to impose) on them. More to the point, all modern

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<sup>43</sup> E.g., Jeff Madrick, *The Case for Big Government* (2008); Krugman; (Revolt of the rich); (Reich); Galbraith,

<sup>44</sup> According to the BLS (Table B-1) out of total US civilian employment of roughly 131 million, about 17% work for the various levels of government, more than half of them as teachers. <http://www.bls.gov/news.release/empsit.t17.htm>. (This number excludes the military, which would add about another percent.) Contrary to American conventional wisdom, these government employees appear to be remarkably productive: forty-two percent of GDP was governmental in 2009, although the numbers may not be fully comparable. [http://www.usgovernmentpending.com/total\\_spending\\_2011USbn](http://www.usgovernmentpending.com/total_spending_2011USbn). Of US private sector workers, the OECD reports that about 34% work in workplaces with fewer than 50 employees and about 52% are in workplaces of over 500; this is the lowest concentration of employment in small workplaces and the highest in large ones in the OECD. <http://noapparentmotive.org/blog/2011/09/09/small-business-bust/> [Check whether this US data is for “workplaces” or “enterprises” – most countries report “enterprises”]. Assuming the data definitions are comparable, this suggests that roughly 40% of employed Americans work for large non-governmental enterprises, including the large publicly traded corporations with which I am concerned, as well as large enterprises in the non-profit sector, such as private universities and hospitals, large closely held for-profit corporations, including all firms controlled by private equity, and large partnerships, such as the major accounting and law firms. Using GDP, the percentage would be lower: the large private sector businesses (including firms that are not publicly traded corporations) accounted for only about a quarter of GDP according to one 1996 estimate. [fbr.sagepub.com/content/9/2/107.abstract](http://fbr.sagepub.com/content/9/2/107.abstract). The figure in the text is a guess based on this partial data.

economies are fundamentally bureaucratic – dominated by institutions that survive precisely because they mitigate intractable planning problems by holding markets at bay.<sup>45</sup>

Our real choice is not between “government” and “market” but how to balance different bureaucracies and where to use markets rather than voting in that balancing process. The competitors are not the self-interested monads of market theory but the bureaucracies we call governmental agencies, the bureaucracies we call professional partnerships, the bureaucracies we call non-profit corporations and the bureaucracies we call business corporations, and the more and less successful iterations of each of those variations.

In each case, the same issues arise: By what structures can we mitigate the inherent problems of information flow, mission-drift, incompetence and corruption that plague all bureaucracies? How should the professional bureaucrats govern themselves? To what degree should we or can we make the enterprise answerable to its own professional and non-professional employees, to its customers or dependents, to the individuals or institutions that provide its financing, to the general public?

Should that responsiveness, however direct or indirect, be filtered through the political mechanisms of voting or through the market mechanism of price? If the former, who should vote and on what basis -- do we draw electoral boundaries geographically or (as in modern corporate law) functionally; should we allocate votes democratically or (as in modern corporate law) per dollar? If the latter, what should be the basic rules of this market, and how do we need to adjust them for the failures of price to reflect externalities, its inability to solve free-rider problems, its tendency to self-destruction in the common circumstances of diminishing marginal costs and marginal cost below average cost, the undue influence it gives to the whims of the rich over the needs of the middle class, let alone the poor, or the inevitable tendency of “free” contracting to shift surplus and rents upwards? When do we use internal voice, when market and when other mechanisms to force the reform or demise of bureaucracies that have lost their way, failed to solve their internal problems, or simply become out-moded?

Most importantly, we need to recognize that corporate law is public law in the same way as administrative and constitutional law, and needs to be subject to the same ongoing public debates as those more conventionally public areas of the law. Deep suspicion of excessive governmental power is a powerful part of the American political heritage, shared by left and right alike. We must revive the equal suspicion – common from at least the Jacksonian era until quite recently – of corporate enterprise: just like state governments, corporate governments are an absolutely essential tool to human happiness that can, just as easily, transform into a source of misery. Eternal vigilance is the price of liberty here as well.

Thus, we need to regain a healthy skepticism towards the claims of corporate ideologues of competence, sound motives, and even basic honesty. We need to recognize that the fundamental problems of governance in the corporate sector are strikingly familiar. In the corporate sector just as in the public sector, information is distorted on the way to the top. Deciders surrounded by yes-men make

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<sup>45</sup> Coase, Corporation; John Kenneth Galbraith, *New Industrial State*.

bad decisions. Pluralism of viewpoints, perspectives and information improves decision-making. Power corrupts and local, organizational absolute power corrupts the organization absolutely. Financial interests and public good only are only intermittently congruent. Leaders who are taught that they may use their office for personal enrichment usually do so; bribery distorts judgment and legal bribery distorts it even more. And most important, democracy is the worst of all possible forms of governance, except for the alternatives.

Once we recognize that corporate law is public law, several reforms that now seem radical will instead be mere applications of self-evident truths.

Externally, we need to worry about corporations drifting from their mission as much as we worry about governmental entities accumulating power for power's sake. In our constitutional law, we ought to assume that rights citizens have against the government ordinarily should be available against large corporations as well – not, as current law has it, that large corporations should presumptively have the same rights to resist regulation as citizens do. Corporate freedom is no more human freedom than governmental freedom is; just as we need to protect individuals against the tendencies of governmental bureaucracies to overreach, we need to protect them against the tendencies of corporate bureaucracies to overreach.

Similarly, just as we need to protect the democratic process from the possibility of current officeholders using their office to entrench themselves in power, we need to worry about corporate officeholders using their office for similar purposes. In the public sector, people need freedom of speech to criticize the incumbents and information and transparency for those criticisms to be reality based, while, in contrast, we often need to restrict, or at least regulate, the ability of governmental bureaucracies to lobby their supervisors. The same is true in the corporate sector: the current rule that corporate officeholders have a constitutionally protected right to use the resources of their office to influence legislation and popular opinion in order to maintain their own prerogatives, is precisely backwards. Instead of granting corporations first amendment rights to interfere in politics or privacy rights to limit investigations, we should be seeking ways to assure our own ability to learn what corporate officeholders are doing, through corporate equivalents to ombudsmen, the GAO and open records laws, and to protect our democratic process from the corrosive effects of incumbency, by limiting corporate lobbying and influence. We need First Amendment rights against our firms, not the other way around.

We also need to apply division of powers, that fundamental rule of sound government in the American tradition, to the corporate sector. Externally, this means that ever more powerful corporations must be balanced by equally powerful countervailing institutions. We need to beef up our governmental regulators, on the one hand, and alternative private institutions, such as unions and consumer groups, on the other. Alternatively, or in addition, we need to revive the political understanding of anti-trust, returning to its original political conception to break up too-large corporations even without clear evidence of monopoly pricing in the narrow economic sense.

Internally, division of powers means that corporate law needs to depart from its current “unified executive” model—which, in turn, almost certainly means that it will need to abandon the

permissiveness of the “internal affairs doctrine.” When the powerful are entitled to choose their own law, they will predictably choose the law that allows them to exploit their power in order to accumulate more. But power corrupts. Worse yet, unquestioned power makes its holders unquestionably stupid.

We can no longer afford the destruction that ensues. Instead, we should mandate that large firms follow the basic rules of republican democracy.

Powers need to be separated and conflicting, to create the tensions and debates that lead to creativity and solutions. So, in addition to the top-down bureaucracy enforcing the whims of a Leader that characterizes virtually every major American corporation today, major firms should have a parallel bottom-up, employee elected, structure of supervisors, with limited mandatory powers perhaps resembling those of a university faculty, a shop steward or a hospital’s medical staff. Boards need to represent not only the investor role we call shares, but also longer-term investors more dependent on the firm’s success, including employees and perhaps customers, neighbors and others affected by its contribution (or lack thereof) to the local (or not so local) culture and environment.

Federalism has its problems, but so does excessive centralization. Anti-trust law ought to refocus its concerns. Producing products at the lowest possible price in the short term is a reasonable goal. But other goals are equally or more important. Anti-trust authorities ought to explicitly consider whether centralization of company headquarters in a small handful of cities is in the public interest – increasing concentration of expertise probably increases innovation, although it may also increase group-think – and how much it conflicts with countervailing values – companies tend to provide the best jobs and the most support for the arts and education in their headquarters town. The size of a company is important not only because size can help a company monopolistically or oligopolistically dominate a product market, but even more importantly because it can lead to control of local labor markets or regional or even national political processes. Corporations that are “too large to fail” (and even a good deal smaller) threaten the integrity of the political processes that are essential to keep the firms themselves socially useful. When the regulated control the regulators, the resulting regulations are rarely likely to promote any conception of the public good.

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