

Opinion **Companies**

We must rethink the purpose of the corporation

The idea that businesses only pursue profits leads to dire outcomes

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The business corporation is among the most remarkable of all human innovations. Corporations are warring armies battling for supremacy in markets. The resulting symbiosis between command and competition has proved very fruitful. The unprecedented economic development seen since the middle of the 19th century would have been impossible without the resources and organisational capacities of that great invention — the limited liability joint-stock company.

Yet, as Colin Mayer of Oxford university's Saïd Business School argues in a remarkable and radical new book, [Prosperity](#), all is not well with the corporation. The public at large increasingly views corporations as sociopathic and so as indifferent to everything, other than the share price, and corporate leaders as indifferent to everything, other than personal rewards. Judged by real wages and productivity, their recent economic performance has been mediocre. Furthermore, corporations have been allowed to corrode competition, as [Jonathan Tepper](#) and Denise Hearn argue in another important new book, [The Myth of Capitalism](#). In short, bad ideas have seized the corporation and let competition waste away.

Prof Mayer's main target is Milton Friedman's argument that the purpose of companies is only to make profits, subject to law and (minimal) regulation. Today, this is presented as the obligation to maximise shareholder value. Behind this is the view, which goes back to Adam Smith, that the principal challenge is the "agency problem" — the relationship between owners and agents (the managers). "The problem with the Friedman view," insists Prof Mayer, "is that it is hopelessly naive." It is based on "simple and elegant economic models that simply do not hold in practice".

The idea that businesses pursue profits and only profits, can, he argues, only produce bad businesses and dire outcomes. This is so for three reasons: human, social and economic.

The first is most important. Profit is not itself a business purpose. Profit is a condition for — and result of — achieving a purpose. The purpose might be making cars, delivering products,

disseminating information, or many other things. If a business substitutes making money for purpose, it will fail at both.

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Second, when legislators allowed incorporation of limited liability companies, they were not thinking of profits, but of the economic possibilities afforded by huge agglomerations of capital, effort and natural resources. Not least, the long-term commitments embedded in the corporation allow it to focus on innovation: arguably, the most important contribution of the corporation is to make innovation routine.

Finally, the core theory of the firm is that of the late Ronald Coase, who argued that the market could be a less efficient way of organising production than a hierarchical organisation, because of [transaction costs](#). This is another way of saying that markets are incomplete, especially where long-term commitments are concerned. Yet it is quite illogical to argue that one can ignore this radical market incompleteness when deciding how businesses should be run. If the rationale for the corporation is to substitute relational contracts, and so trust, for explicit contracts, and so enforcement, one cannot ignore this in deciding what businesses are for and who should control them.

How, above all, can such long-term trust be sustained if the constantly reiterated aim of the corporation is to serve the interests of those least committed to it, while control is also entrusted to those least knowledgeable about its activities and at least risk of damage by its failure? Yet these are reasonable descriptions of the place of shareholders in publicly-owned companies with widely-distributed shareholdings.

Shareholders are least committed, because, unlike employees, dedicated suppliers and the locations in which businesses operate, they can divest themselves of their engagement in the company in an instant. Shareholders are the least knowledgeable, because they are not engaged in the activity of the company.

Crucially, contrary to economic wisdom, shareholders are not, in the actual world, the bearers of the residual risks in the business (other than relative to bondholders). The incompleteness of markets ensures that employees, suppliers and locations also bear substantial risk. Moreover, stock markets allow shareholders to diversify their risks across the world, something employees, for example, cannot hope to do with respect to their company-specific capital stock of knowledge and personal relationships. Moreover, everybody else is at risk from shareholders' opportunistic behaviour. This has to weaken the commitment of everybody else.

In addition, given the mantra of shareholder value maximisation and the inability of

shareholders to monitor management, rewards have increasingly been linked not to the performance of the business in delivering on its purposes, but to accounting profits and the share price. Yet both are subject to manipulation. Some would argue that the result has been excessive remuneration, (the theme of [Are Chief Executives Overpaid?](#) by Deborah Hargreaves) and chronic under-investment, too.

These books suggest that capitalism is substantially broken. Reluctantly, I have come to a similar conclusion. This is not to argue for the abandonment of the market economy, but for better companies and more competition.

The implication of Prof Mayer's book is that the canonical Anglo-American model of corporate governance, with equality among shareholders, widely distributed share-ownership, shareholder value maximisation and the market in control is just one of many possible ways of structuring corporations. There is no reason to believe it is always the best. In some cases, it works. In others, such as highly-leveraged banking, it really does not. We should be explicitly encouraging a thousand different flowers of governance and control to bloom. Let us see what works.

At the same time, the implication of Mr Tepper's book is that, just as we have been too careless in thinking about the nature and purpose of the corporation, so, too, we have been careless about the markets in which they are embedded.

The bigger the corporations, the more competitive must be the markets. The corporation is indeed a great invention. But what has made their contribution so remarkable has, above all, been the competitive markets in which they are embedded. The weaker the competition, the less their profits will tell one about a company's real economic contribution. We must fix the corporation and competition, together.

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