The Nature of Economic Freedom and Economic Hierarchy: Theoretical Assumptions Underlying American Corporate Law and Corporate Governance

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This paper attempts to disclose the theoretical presuppositions which underlie the economic defense of North American corporate governance and corporate law practices. The constraints placed on managerial behavior from both internal governance practices or external legal institutions are, to put it bluntly, minimal if not meaningless. Shareholder influence and control over managerial action remains prostrate, despite the rise in "say on pay" policies in many public corporations, and overhauls in the regulation of shareholder voting following the 2008 financial crisis. Compensation consultants still wield far more influence than shareholders do in determining executive compensation, and ballot entry on proxy votes are still largely controlled by executives and boards of directors, drastically limiting the extent of shareholder involvement or governance.

From the outside, legal intervention or reprimand of managerial negligence occurs only in the most extreme of situations. Many progressive critics of the corporation often bemoan the emphasis that corporate law places on "profit-maximizing," claiming that the law's focus on corporate profit neglects the myriad other values that corporations ought to consider. While it may be true that corporations ought to pursue other values, this criticism fails to realize how little corporate law does in forcing corporate decision-makers to pursue profit-maximizing strategies. Because of the "business judgment rule," courts interpret the fiduciary duty of management in incredibly thin ways, showing a maximum of deference to executive decisions, whether or not such decisions can be shown to maximize profit in any real way. This has led some to argue that

a corporate manager is more likely to get struck by lightning outside the courthouse than to ever have to pay damages within it.

This paper looks into the theoretical presuppositions that underlie this regime. What are the ontological assumptions and normative commitments implied by the way corporations are structured in our current legal and economic system? My argument is that these features of corporate law are the product of the Chicago economic project, its libertarian bearings resulting in a regime in which corporations are reduced to a nexus of transactions, and managerial behavior is presumed to be efficient and legitimate unless in blatant contradiction with a prior agreement. This extension of the Chicago project into corporate affairs rests on a number of significant and controversial commitments. The first, and most obvious, is the normative prioritization of efficiency over other social values. This hallmark assumption comes with two other assumptions when applied to the internal relationships of the corporation: first, those sets of relationships that appear to be efficient are assumed to be either the result, or an approximation, of market-derived outcomes; and second, that individuals' preferences are exogenous to their settings—people's preferences are not affected by the institutions and contexts that frame their interaction.

After some methodological notes, I begin with the challenges that progressive social critics levied against the modern business corporation in the first half of the 20th century. These criticisms largely centered on the separation of corporate ownership from corporate control. This posed a major theoretical challenge to the legitimacy of liberal capitalism in the early 20th century. If one's foundational assumption is the primacy of liberty, then on what grounds can the seemingly unaccountable authority and hierarchy of economic enterprise be justified? In this light I argue that the development of the economic theory of the firm ought to be seen as an

intervention into the political theory of liberal democracy. We see economic theories of agency and property rights develop in order to deny the existence of corporate authority in the first place, and by insisting on the economic efficiency of extant relationships. These were all necessary theoretical moves to reach what is now the status quo in North America. I conclude that these foundational theories and assumptions assumption are incoherent: if we grant the assumption that corporations exist in order to achieve efficiency gains, such efficiency gains can only be made sense of by recognizing the way in which corporate institutions alter individuals' preferences, and the necessity of recognizing the non-market nature of corporate orderings. Thus, even if we accept Chicago's emphasis on efficiency, we must recognize the fact of corporate power, which invites questions as to its legitimacy and overreach. These considerations, I contend, should inform assessments and changes to how we reconcile current corporate practices with our overarching political and social values.

What is the Chicago School?

Chicago's Most Famous Critic

The most important work of political theory criticizing the Chicago economics project is likely Michel Foucault's *The Birth of Biopolitics*. Foucault argued that Chicago economics[1] had radically recast the political subject, simultaneously depoliticizing her while also making her more susceptible to governance by economic logic. The aim of this paper is not to offer a critique of Foucault; however, given the importance of this text it is worth saying a few words about the how the current study relates to Foucault's analysis. Like Foucault, I take the Chicago project as being fundamentally an attempt to bring non-economic subjects under the scrutiny of economic analysis. Our current practices in corporate law and corporate governance are the result of

[1] Foucault used the term "neoliberal" to describe this tradition. This term has now come to encompass much more than simply Chicago style economic thinking. For that reason I avoid using this term here.

Chicago scholars who wanted to show the relationships *within* the corporation to be governed by the market's price mechanism.

The bulk of the differences between Foucault's account and my own are methodological. Most obviously, Foucault does not mention the corporation, either as a development in 20th century capitalist economies, or as a focus of Chicago economics. For Foucault, Chicago economics was fundamentally responding to the development of Keynesian economics and the growth of the American welfare state,[2] while I suggest a different area of economic intervention - corporate law and corporate governance - that Foucault does not touch upon. More substantively, there is a subtle distinction in how I understand the project of Chicago economics that is worth emphasizing, as it makes clear how I view the connection between the Chicago program, the economic theory of the corporation, and its significant normative political theoretic implications.

Foucault contends that the hallmark of the Chicago project is taking phenomena left untouched or un-theorized by classical political economy and bringing them under the scope of economic analysis. In a telling passage, Foucault describes the core features of Chicago economic analysis: "for the neoliberals economic analysis should not consist in the study of [production, consumption and distribution], but in the nature and consequences of what they call substitutable choices, that is to say, the study and analysis of the way in which scarce means are allocated to competing ends, that is to say, to alternative ends which cannot be superimposed on each other."[3] In other words, Foucault takes Chicago economics to be defined by its use of principles associated with the Marshallian system of political economy built upon it. There are a couple of peculiar things about this. The first is that the analytical concepts to which he is referring were developed roughly half a century prior to the emergence of the Chicago school;

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[2] Michel Foucault. 2010. *The Birth of Biopolitics: Lectures at the College de France, 1978-1979.* Trans. Graham Burchell. New York: Palgrave Macmillan, 79.
[3] Foucault, 222.

the labor theory of value was more-or-less debunked by the marginal theory of utility by the end of the 19th century, transferring the attention of economics away from population control and toward the competing use of scarce resources. Certainly we would not consider Pigou to be a neoliberal, despite his systematic use of marginal utility theory.

The other peculiar thing is that Foucault doesn't explain in non-arbitrary or non-trivial terms what the distinction is between the economic and the non-economic, such that using the analysis from the former to engage the latter would be noteworthy. To a certain degree Foucault doesn't need to do this: insofar as Foucault is largely concerned with how Chicago challenged previous modes of economic analysis, all he really needs to do is show how such phenomena were previously not under the scrutiny of economists, which he does. However, most have taken his account to be an attempt to show something insidious about the Chicago paradigm, and its imperial attempt to extend the economic into the social. Insofar as the analysis is supposed to have any kind of critical bite a more precise understanding of the distinction between the economic and the non-economic is necessary to make the radicalism of Chicago clear.

While Foucault is right to point out that Chicago economics emphasizes the margin, substitution, and scarcity, it is more helpful to understand their analyses in terms of the presumed outcomes of markets. Another way of putting this is that Chicago does not simply apply economic tools of analysis to non-market behavior, but applies a particular brand of price theory to such behavior. As a result Chicagoans treat various incentives and disincentives as prices that had previously been excluded from such analysis.[4] This is important because Chicago price theory (especially its later variants) departed from its Marshallian origins in a number of ways. First, whereas Marshall suggested that scarcity pricing determined by supply and demand has the

[4] Nicholas Mercuro and Steven Medema. 2006. *Economics and the Law: From Posner to Post-Modernism and Beyond, 2nd Edition.* Princeton: Princeton University Press. 97.

potential to allocate goods in a way superior to alternatives, Chicagoans took that conclusion as the basic operating assumption; the normative benefits of the market's price mechanism are therefore foregrounded by the theory. It is telling, to this end, that the first economics class that Milton Friedman taught in Chicago features only one text by Hayek, which is "The Use of Knowledge in Society."[5] The emphasis is on the informational gains that come with market prices, and has less to do with the things that go into constituting that price. Put differently, the economic tools that Chicago wields have less to do with the fact that they translate peoples' choices and actions in terms of scarcity, substitution, and marginalism, and more to do with the underlying idea that such decisions, when not interfered with, will result in an optimal allocation.

The second major distinction between Chicago's price theory and early variants can be found in Stigler's canonical work on the subject, where the rational utility maximizer is made central to the theory.[6] Such an assumption had not been nearly as central to previous economic theory; Smith, Marshal, and even Friedman, all made a point of *not* stipulating as a fact that all actors are economically rational. In contrast, Stigler made this assumption a foundational premise. Stigler reread the history of political economy going all the way back to Smith as being "a stupendous palace erected upon the granite of self-interest,"[7] and made the this behavioral premise a special place in explaining, as opposed to merely predicting, the function of markets. This was the key shift in method that allowed Becker's analyses, which so fascinated Foucault.

This allows us a more precise understanding of how Chicago attempts to extend the domain of the economic: the goal is to show that price theory holds in areas where it was thought not to previously apply. This can be thought of in two different ways. On the one hand, there are

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[5] J. Daniel Hammond. 2010. "The Development of Post-War Chicago Price Theory, Appendix 1A2 'Syllabus for Economics 300.'" In *The Elgar Companion to the Chicago School of Economics*, ed. R Emmet. Cheltenhanham: Elgar Publishing, 23.

[6] George Stigler. 1966. *Theory of Price*. New York: Macmillan, 60.

[7] George Stigler. 1971. "Smith's Travels on the Ship of State." *History of Political Economy* 3: 265 (265-277).

attempts to show how the allocative side of price theory holds in contexts where prices were previously thought to malfunction and misallocate. We can think of this as using economic analysis to vindicate the economic, to show how phenomena thought of as irrational aspects of markets are in fact rational. On the other hand, Chicago projects also aim to show how positive outcomes previously thought to be the result of non-market practices are, in fact, the result of markets, or something akin to them, which explains their optimality.

As a result, Chicago is largely concerned with showing how superfluous non-market mechanisms are. This is tied to the familiar political project of limited government in a straightforward way; because misallocation of the price mechanisms constitutes a "prima facie case" for intervention (to use Pigou's language[8]), to show that the market is in fact working as it ought to implies a charge against intervention. Similarly, to show that "non-markets" are only functioning well because their incentives are functioning like prices implies the case for the extension of markets. Where markets exist, Chicagoans attempt to show the results to be optimal; where results are optimal, Chicagoans attempt to show that markets exist. With a slight perversion of Hegel's dictum, we can encapsulate the idea in this way: *What is market-based is optimal; and what is optimal is market-based.*

An Instructive Example

Perhaps the best and most famous example of "what is market-based is optimal" is what is known as the "Coase Theorem," or the argument derived from Ronald Coase's "The Problem of Social Cost."[9] This is not only a helpful example for understanding Chicago analysis; it helps

[8] Arthur Pigou.1932/1920. *The Economics of Welfare.* London: Macmillan and Co, II.XX.4

[9] Ronald Coase. 1960. "The problem of social cost." *Journal of Law and Economics* 3: 1-44. I make this distinction because I distinguish between Coase's actual intention, and what has become known as the "Coase Theorem," which was coined by Stigler (George Stigler. 1966. *The Theory of Price, 3rd Edition*. New York: Macmillan Press).

clarify things about Coase's place within this tradition. The Coase Theorem holds that it does not make a difference whether one deals with externalities through private contracting or through the legal assignment of liability; either will yield the same result, the efficient result, given the assumption of zero transaction costs. To understand the logic of this, imagine a hot sauce company whose factory gives off pepper fumes that disrupts the lives of its neighbors. This is a clear-cut case of negative externality. Now, imagine that the neighbors sue and the judge rules that the hot sauce manufacture was violating the rights of its neighbors. Let us say that the hot sauce company has a huge interest in keeping its location because of its proximity to a pepper patch. If it is that profitable for them to stay—more profitable for them to stay than it is costly for the neighbors to leave—then even despite the ruling, the hot sauce company will pay its neighbors to compensate them for the inconvenience of the pepper fumes, or to offset the costs of moving away, and will remain in business. If the court had ruled the other way—that the hot sauce company had the right to manufacture hot sauce where it was—then, assuming nothing else changed, the hot sauce company would still keep operating since the neighbors would not be willing to pay the amount necessary to get the hot sauce company to close shop or move.

The point is that, given the value of the hot sauce company location relative to the displeasure of its neighbors, the end-result will be the same regardless of who a court of law finds liable. Parties will bargain and compensate others to the extent that they are willing; legal assignment of liability will only be conclusive insofar as it approximates the assignment of payment that would have been reached through a bargaining procedure. From this perspective, it is not obvious what the state is adding by intervening. Here, the normative payoff is that the existence of negative externalities produced by markets is not in fact so negative. The existence is actually the optimal allocation produced by a market for ownership rights.

This is a slight but important perversion of Coase's argument, who was actually more concerned in showing the pervasiveness of transaction costs. Still, understanding this interpretation of Coase helps us understand something about the Chicago approach to the corporation; it is based on this strand of "Coasian" thought, and is a deliberate departure from earlier Coasian ideas about the nature of the firm. Coase's "The Nature of the Firm"[10] contended that the efficiency of the firm was due to its distinction from the market—its supersession of the price mechanism in favor of entrepreneurial planning. The later generation of Chicago scholars sought to show that the firm was itself nothing but a market. Thinking about Chicago in terms of the "two Coases"[11] – 1937 and 1960 – where Chicago scholars emphasized the latter and read the former through that lens, is helpful for understanding the broader development of our theory of the corporation. The problems of market failure that Coase's 1937 article articulated were washed away by Chicago scholars using his 1960 article. They took the Coasian idea that the firm is an efficiency-improvement over private contracting, and turned it around by asserting that there is no distinction between the firm and private contracting. If the firm is an improvement in efficiency, then it must be an example of price theory at work—"What is optimal is market-based."

However, Chicagoans did not generally take their analyses as being a departure from Coase, since they saw Coase as the Godfather of their style of inquiry. Instead, the target of Chicago analyses was what is known as managerialism. This is the subject of the next section.

The Corporation as Node of Power

[10] Ronald Coase.1937. "The nature of the firm." *Economica* 4(16): 386-405.
[11] Steven Medema. 1994. The Myth of two Coases: What Coase is Really Saying." *Journal of Economic Issues* 28(1): 208-217.

It is perhaps telling that what is roundly considered a pivotal moment for the development of the Chicago school was the hiring of Aaron Director (who was trained as an economist) to teach a course on antitrust law as a member of the law school faculty. Antitrust is the specific domain of law where Chicago price theory cut its teeth on legal analysis. Medema has referred to antitrust law as the quintessential Chicago project, both in terms of illustrating its mission, and in terms of its success in influencing public policy.[12] The first issue of the *Journal of Law and Economics* featured a criticism of the *Standard Oil*, arguing that Standard Oil's monopoly had not resulted from predatory pricing, but through buying out its rivals.[13] Chicago's law and economics tradition was born out of a rejection of prevailing legal and economic approaches to the corporation. For anti-trust policy, the prevailing approach is what is known as the Harvard School of industrial organization. For the theory of corporate governance, corporate law, and business ethics, the prevailing approach to the corporation was managerialism, exemplified by Berle, Means, Galbraith, and Keynes.

While the Harvard school and managerialism are distinct in many ways—the Harvard school was not terribly concerned with the internal dynamics of the corporation, and managerialism took monopoly to be a largely solved problem—they represented similar targets for the Chicago school because of their common emphasis on corporate power. For the Harvard School, a decentralized competitive market was meant to check private power; the large corporation compromised this function and therefore needed to be regulated and checked.[14] Pre-

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[12] Steven Medema.2010. "Chicago Law and Economics" in *The Elgar Companion to the Chicago School of Economics*. Edited by Ross Emmett. Cheltanham: Elgar Publishing.164 (160-174).

[13] John McGee. 1958. "Price Cutting: The Standard Oil (NJ) Case." *Law and Economics* 1(1): 137-169.

[14] Legally this found grounding in Learned Hand's famous interpretation of the Sherman Act in his *US. v. Aluminum Company of America* decision. The legal question was not whether a monopoly was achieved for good or bad reasons; instead, because of market power's "indirect social or moral effect," Sherman was to be interpreted "to prefer a system of small producers, each dependent for his success upon his own skill and character, to one in which the great mass of those engaged must accept the direction of a few." (Learned Hand. 1945. *United States v. Aluminum Company of America*. 148 F.2d 416)

Chicago Harvard antitrust scholarship, therefore, saw curtailing the size of the corporation as being in service of decentralizing power across a competitive market.[15] In a similar vein, pre-Chicago managerial approaches to the corporation saw the internal dynamics of the corporation as being largely about the nature and use of corporate power to direct its various resources (human, financial, and otherwise). By understanding how the managerialist view of the corporation cashed out in a normative account of how the corporation ought to be organized, we can better understand the response of the Chicago school.

Managerialism, ownership, and control

Managerialism refers to theoretical approaches that highlight the structural nature of corporations that empowered managers, giving them control over other members of the corporation. Managerialism might be thought of as a largely ontological position that starts from the assumption that power is one of the more important facts of the economy. The most famous example of this methodological emphasis on power in 20th century economics is Galbraith. Though his idea of "countervailing power"—where the concentration of power in industry spurs on the concentration of power in response (for example, in unions)—is the best known of this methodological focus, Galbraith was also deeply concerned with the exercise of power by managers within the corporation.[16] From these stipulated facts about the corporations—that it is a structure and that managers possess power within it— there of course arose many variants. Some

[15] Or as Kaysen put it: "the chief virtue of a competitive market in practice is not necessarily that it leads to economic efficiency that it constraints private economic power…. In the evolving giant corporation, managers possess great scope for decision making unconstrained by market forces—nowhere more so than in their decisions with respect to future growth and change. (Carl Kaysen.1957. "The Social Significance of the Modern Corporation." *The American Economic Review* 47[2]: 316 [311-319]).

[16] To take one example, in discussing the growth in size and complexity of the modern corporation, Galbraith argues that "power passed beyond the intellectual reach of the nonparticipant and thus beyond his or her capacity to intervene effectively. And increasingly within the enterprise, decisions emerged not from the single competence of any one individual but from the several contributions of specialists meeting in committee or close daily association." (John Kenneth Galbraith. 1983. *The Anatomy of Power*. Boston: Houghton Mifflin, 134.)

managerialists saw these facts in a positive light, contending that managerial power was justified by managers' expertise and merit.[17] The more influential strand of managerialism was critical, contending that managerial power was illegitimate and harmful on its face.

The locus classicus for critical managerialism is Berle and Means' *The Modern Corporation and Private Property.* While sometimes thought of as simply a critique of contemporary corporate practice, Berle and Means' project is better seen in more grandiose terms: their argument is that the development of the corporation represents a radical and new system of property and production. Berle and Means contend that the development of the factory system in the industrial revolution, which placed large amounts of labor under the direction of a few managers, has now been coupled with the corporate structure that places large amounts of capital under the direction of the same few people.[18] This second movement has effected a large change in the nature of property: first, in that the emphasis on corporate securities markets has made liquid property more abundant than non-liquid or fixed property;[19] and second, as a result, property itself has been decomposed into "nominal ownership" and control. With ownership and control utterly severed ("the dissolution of the atom of property") the corporation takes on a "quasi-public" status, resulting in the destruction of "the very foundation on which the economic order of the past three centuries has rested."[20] The corporation's dominant status in American capitalism therefore represents nothing short of a revolution in political economy.

While the language used to describe this transformation is quite clearly negative, the basis of the critique is not as straightforward. At times it appears that Berle and Means are

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[17] See, for example: Edward S Mason. 1958. "The Apologetics of Managerialism." *The Journal of Business* 31(1): 1-11; David E. Lilienthal. 1952. *Big Business: A New Era*. New York: Harper & Brothers.
[18] Adolf Berle and Gardiner Means. 1932 (2009). *The Modern Corporation and Private Property*. New Brunswick: Transaction Publishers. 5
[19] Ibid, 249-252.
[20] Ibid, 8-9

concerned with the corporation as a new institution that was crippling Smith's invisible hand. While there are numerous parts of Berle and Means that dwell on the inefficiencies of the corporate system, this is not their only concern, nor is it their most compelling claim. More compelling is Berle and Means' critique of the corporation on behalf of normative political and legal ideas. This critique is implied by the political language used, where corporate managers are the new "princes" of industry, and corporations are new "economic empires."[21] There are also many references to how this change in property results in a change in the property-holder, destroying the virtue, responsibility, and community that comes with the ownership and control of real fixed property.[22] These suggest the more potent criticism that corporate and managerial power is problematic because of their illegitimate, illiberal, and immoral nature.

For Berle and Means, the modern publicly traded corporation represents a significant change in the how control over property works. In the closed corporation the owning party has full power to direct, or hire directors of, the enterprise as it sees fit and can therefore be seen as the control. In cases of majority control, while the party with the most shares still has great control, certain unilateral powers are ceded, like the power to alter or suspend the corporate charter, or disband the enterprise, all of which generally involve some form of supermajoritarian procedure. These are largely in line with the older, traditional "atom of property" upon which classical economics is based. The prevalence of "minority control" and "management control" in the modern corporation represent crucial developments for Berle and Means because they are forms of de facto control; the legal right to control is rendered nominal and another party holds

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[21] Ibid 114, 116.

[22] See, as one example, Ibid 64-65: "The spiritual values that formerly went with ownership have been separated from it. Physical property capable of being shaped by the owner could bring to him direct satisfaction apart from the income it yielded in more concrete form. It represented an extension of his own personality. With the corporate revolution, this quality has been lost to the property owner much as it has been lost to the worker through the industrial revolution."

factual control. Anachronistically, we can say that this is product of the Downsian insight that the cost of voting tends to outweigh the advantages of voting when the electorate is sufficiently large; the result is that the party possessing enough resources to solve the collective action problem and mobilize voters will tend to have disproportionate influence by virtue of commanding not just its votes, but the votes of all those it has mobilized. Minority control of the corporation is simply when this collective action problem is solved by a minority-owner.

The more pervasive and significant tendency, according to Berle and Means, is for this collective action problem to be solved by the managers themselves, which renders management in control of the corporation. This is done by the creation of a proxy committee, who collect the proxies of those shareholders, essentially transferring the voting control over management to management itself. [23] Management control is therefore the result of the corporation growing in size such that though every investor has the legal right to dictate control over the enterprise, this right is hollow in fact. Management assumes control over itself because it alone possesses the power to mobilize and command proxy votes. It is worth noting that Berle and Means were not able to fathom how the growth of institutional investors would exacerbate this problem. Because institutional investors—like banks, hedge funds, and pension funds—own a large percentage of stock in general, and own this stock in many corporations, the cost of voting becomes even greater, since a share in one corporation is only a fraction of the fund's diverse holdings.[24]

Those who have a right to control in law are, in the new corporate system, divorced from this right in practice. This raises two normative problems. The first is that the corporation has come to eclipse liberal individualism.[25] The other normative problem was that this rendered the control of the corporation illegitimate. As Berle describes elsewhere, the wielding of (and

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[23] Ibid 82.
[24] See Ronald Davis. 2009. *Pension Fund Democracy.* Vanouver: UBC Press
[25] Berle and Means 116.

subjection to) power is always accompanied by an implicit or explicit claim that "power lies there because the holder is entitled to it by some test or standard"; as a corollary, this claim to legitimacy also implies that "the holder can be deprived of it if demonstration is made that there is no title or right in his possession of it."[26] Because the test or standard that gives corporate power its legitimacy is the shareholder vote, and because the shareholder vote has been reduced to the self-selection of management, management rule is illegitimate. As the shareholder vote becomes more and more nominal, the mandate and legitimacy of management becomes more and more hollow.

Berle and Means consider the possibility, however, that even if those wielding the power might not be doing so legitimately, they might still be pursuing legitimate ends. Phrased differently, there is a distinction between the legitimate possession of corporate power and the legitimate use of such power.[27] The use of power is legitimate if it is "appropriate to the function of the organization," which for the business corporation is "the ratable benefit of all the shareholders as their interest appears"; corporate power, no matter how legitimate its possession, is subject to legal limitation "when the power has been exercised to the detriment of [shareholders'] interests."[28] This is essentially an assertion of the familiar idea of fiduciary responsibility, where managers must act in trust for the benefit of their shareholders. When their actions are not in the interests of their shareholders, they are in violation of that trust and, therefore, in violation of corporate law. Berle and Means read fiduciary duty in thick terms, asserting that such legal limitations hold even if there is language in the corporate charter that might protect particular actions; to do otherwise would be "to defeat the very object and nature

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[26] Adolf Berle. *Power without Property: A New Development in American Political Economy.* New York: Harcourt, Brace, and Co. 98.
[27] Ibid 99; Berle and Means, 221.
[28] Berle 102; Berle and Means 221

of the corporation itself."[29] The legal purpose of the corporation restricts the ends of the corporate enterprise, restricting the kinds of actions corporate managers can pursue legitimately.

A large part of the managerial critique is that these legal doctrines are not enforced by courts, giving a large amount of latitude to managerial discretion; the legal enforcement of fiduciary duty has gone the way of shareholder control, in this view: nominal holdovers from a pre-corporate economic system that no longer have any real force or effect on economic activity. The modern shareholder has "surrendered a set of definite rights for a set of indefinite expectations," and finds herself limited in the kinds of legal demands she can make on the corporation.[30] Berle and Means put this critique in political terms, drawing on an analogy between the corporate enterprise and communist government. This is a familiar trope that can be found in other institutionalist and managerialist writing.[31] Berle and Means articulated this with reference to the subordination of the individual to the collective in both systems of production. [32] These political analogies are instructive. The shareholders are to the corporation what the public is to the state (the source of legitimacy), and corporate law is to the management what a bill of rights is to the state (protections of those subject to rule); as a result, shareholders without the protection of corporate law are to the corporation what citizens of communist countries are to the state (subjects of illiberal rule). The fact of corporate law's impotence renders the corporation not merely an instance of the illegitimate possession of power, but the development of an illiberal and anti-individualist institution.

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[29] Ibid 242.
[30] Ibid 244.
[31] Again, the most famous example is Galbraith, whose theory of convergence contended that capitalist and socialist economies were converging toward a common form of bureaucratic planning. For example: "There is no tendency for the Soviet and Western systems to convergence by the return of the former to the market. Both have outgrown that. There is measurable convergence to the same form of planning" (John Kenneth Galbraith. 1967 (2007). *The New Industrial State*. Princeton: Princeton University Press. 136).
[32] Berle and Means, 245.

This failure of the corporation to abide the principles of legitimacy has rendered it something distinct from the liberal ideas of competition and private enterprise. With this, Berle and Means conclude that liberal-democratic ideas of individuality, legitimacy, and equality are no longer apt to the modern corporation. The corporation is now, Berle and Means famously conclude, a social institution, and must be recognized as such. Because shareholders can no longer be plausibly viewed as having control, the corporation ought to be controlled by society until it becomes "a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity."[33] As the corporate institution becomes more severed from the shareholders who formally own it, it ought to pass further into the realm of public accountability.

More can be said about critical managerialism in general, and about Berle and Means' project in particular. However, we can conclude here by noting that managerialism's empirical claims—the corporation is a structure that vests hierarchical power within a select group of managers—are joined by Berle and Means with familiar ideas of legitimacy that provide strong critical and prescriptive stance on corporate governance and law. The corporation is no longer controlled by those who own, but rather by those who act in unaccountable ways. The normative prescription is for statutory and public governance of the corporation. The legal rights of shareholders are no longer effective or even existent. The normative prescription is to bring corporate law within the domain of public law, as this better reflects the individual shareholder's relationship and vulnerability to the large enterprise. As a result, the gauntlet was thrown down for those who wished to adhere to such classical liberal principles and defend the corporation: how could the modern business corporation—powerful and unaccountable as they were painted to be—be reconciled with their emphasis on individualism and liberty? How could the

[33] Ibid 312-313.

corporation be conceived as anything other than a social institution that overcame and dominated individuals? For libertarianism or classical liberalism to have any coherence, the problem of the corporation and its power had to be resolved.

Chicago Business Ethics: Friedman's Opening Salvo

Friedman's classic 1970 article, "The social responsibility of business is to increase its profits" (and the chapter in his famous 1962 book upon which it is based), is presented as a refutation of the idea of "corporate social responsibility." Since then the idea of corporate social responsibility (CSR) has grown in prominence, complexity, and controversy, taking on meanings and debates that were not familiar to midcentury scholars. The idea of CSR—the idea that corporations have some ethical duty to engage in actions that directly and explicitly benefit society in some way—has a direct link to Berle and Means' claim that the corporation is now a social institution, beholden and responsible to the society that creates it. While Friedman is certainly critical of CSR—and, by extension, of Berle and Means' normative conclusions—focusing on this misses the more radical challenge that Friedman makes to the managerial view of the corporation.

The underlying claim that Friedman asserts—since he does not really offer an argument for it in the 1962 or 1970 pieces—is that the very idea that the corporation is a "structure" is nonsense. For Berle and Means the modern corporation represented the dissolution of liberal and individualistic ideas of property, in which to own means the ability to control, and therefore created new forms of power. For Friedman, this development was not anything new or revolutionary. The corporation was not a new system of property, but simply an arrangement

where some people worked for others. Put simply, it is a principal-agent relationship.[34] The fact that shareholders "own" and managers "control" the corporation's property is not laden with the normative implications managerialists want to place on it, since all sorts of relationships involve people acting on behalf of others, none of which imply some revolutionary system of political economy.

Friedman's claim that that the corporation is governed by a principal-agent relationship need not inherently be so different from the managerialists. The fact of managerial control and corporate power could be conceived of as a broken-down principal-agent relationship where the agent was now able to exploit and defraud the principal. Against this, Friedman simply asserts the contrary: "a major complaint against modern business is that it involves the separation of ownership and control—that the corporation has become a social institution that is a law unto itself, with irresponsible executives who do not serve the interests of their stockholders. This charge is not true."[35] To understand properly Friedman's provocative normative conclusions—that business has the sole ethical mandate to "use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game"[36]—it helps to try and figure out Friedman's reasoning (since he does not actually defend this position) for rejecting the Berle and Means thesis that corporate managers had become unaccountable to the shareholders whose interests they represent.

In one of the most influential essays in the history of economics, Friedman made the claim that the assumptions underlying a theoretical model need not be realistic or true, as long as

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[34] Milton Friedman. 1970. "The Social Responsibility of Business is to Increase its Profits." *New York Times* September 13. Reprinted in *Management of Values: The Ethical Difference in Corporate Policy and Performance* (1985) ed. C McCoy. Boston: Pitman, 253-260.
[35] Milton Friedman. 1962. *Capitalism and Freedom*. Chicago: University of Chicago Press. 135.
[36] Friedman, 1962, 133.

they lend themselves to effective predictions.[37] So, to recite his famous example, one might try to explain the density of leaves on a tree from the theory that that leaves act as if they were deliberately trying to gain as much sunlight as possible. While the assumption underlying this theory is patently false since leaves don't do anything deliberately, the predictions it leads to are generally confirmed by experience and investigation: leaves are crowded more densely on the southern face of trees, and tend to be less crowded on the north or in sunlight-obstructed areas. Because the latter is the class of phenomena that is meant to be explained, it is of little consequence that the assumptions are unrealistic.

This is significant for our purposes because Friedman segues from this example of leaves into the question of the profit-maximizing firm: is the model of microeconomics flawed because it assumes that all firms seek to maximize profits? The answer depends on how useful the assumption is for predictive purposes: "unless the behavior of businessmen in some way or other approximated behavior consistent with the maximization of returns, it seems unlikely that they would remain in business for long….given 'natural selection,' acceptance of the hypothesis can be based largely on the judgment that it summarizes appropriately the conditions for survival."[38] Empirically speaking, we don't need to know anything about the actual determinants or character of managerial decision-making. The only thing we need to know is that, given the context of a competitive market, businesses will tend to behave as if their managers were consciously and singularly pursuing the maximization of profit; put differently, making such an assumption is justified because doing so allows for the most accurate predictions of business behavior.

So, why is it false to claim that the separation of ownership from control has resulted in an overly-brazen corporate management? It is because doing so assumes such a separation

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[37] Milton Friedman. 1953. "Methodology and Positive economics," in *Essays in Positive Economics.* 30-31.
[38] Ibid 158.

matters in the first place. The actual micro-determinants of a given manager's decisions are less important than the fact that managers will tend towards profit-maximization by virtue of the pressures that markets supply. That is, the fact that owners are not able to exert any sort of "control" over their managers does not mean that their interests are not being served by their owners; if we assume, along with Berle and Means, that the stockholders' interests lie in the maximization of returns, then they don't need an effective vote to assure this. The "natural selection" of the market does this just fine.

This raises a question: if the market will tend to push executives toward shareholder interests in the first place, then why would the firm have a "social responsibility" to maximize its profits? Wouldn't this be less of a responsibility and more of an inescapable fact? The reason why it has ethical connotations for Friedman is because doing otherwise will tend to undermine the competitive free market as a whole if pursued by all. Hence the claim that the businessmen who claim to be concerned with social ends in addition to profit—such as "providing employment, eliminating discrimination, and avoiding pollution"—are not actually bolstering the standing of free enterprise, but rather are "preaching pure and unadulterated socialism."[39] The competitive and free market is not simply a system of property rights and enforcements, but a mutual recognition that all have the right to pursue their own interests to the best of their legal ability. So, although Friedman wants to claim that given a market context firms will tend to maximize profits, the growing "corporate consensus" that firms have "social obligations" has the effect of thwarting the very existence of the free market, and is therefore "a step in the direction of creating a true divorce between ownership and control and of undermining the basic nature

[39] Friedman, 1970, 253.

and character of our society."[40] The result is that shareholders will be robbed of the main institutional check that keeps managers working in their interest.

To better explain this idea we can start with the assumption that the manager is the agent in two distinct principal-agent relationships—with the shareholder on one hand and with the stakeholder (our stand-in for "social concerns") on the other.[41] One might read Friedman as claiming that to focus on the second relationship is to abandon one's duties in the first. For an executive to pursue "social responsibility," on Friedan's account is simply to take someone's money and spend it on a purpose they did not intend. In this sense, to pursue something other than profit-maximization would be socially irresponsible because it promotes shirking. The best hedge against such exploitation of this relationship is the free market, which is fundamentally about unanimity: "no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate."[42] If the executive does something "socially responsible," like make a donation to a charity from corporate coffers, she "prevents the individual stockholder from himself deciding how he should dispose of his funds."[43] To pursue CSR is to violate the unanimous form of cooperation that the market produces.

This actually brings us to a larger and stronger thesis, which is what Friedman appears to mean: emphasizing one's principal-agent relationship with the stakeholder over the shareholder has the effect of shirking responsibilities to *both* relationships! While engaging in CSR has the apparent effect of lessening a manager's commitment to shareholder interests, Friedman argues

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[40] Friedman 1962, 136.

[41] Here, I follow Salazar and Husted in their approach to Friedman's account of CSR: Bryan Husted and Jose Salazar. 2006. "Taking Friedman Seriously: Maximizing Profits and Social Performance." *Journal of Management Studies* 43(1): 75-91; Jose Salazar and Bryan Husted. "Principals and Agents: Further Thoughts on the Friedmanite Critique of Corporate Social Responsibility" in *The Oxford Handbook of Corporate Social Responsibility* (2008) eds A Crane, A McWilliams, D Matten, J Moon, and D Siegel. Oxford: Oxford University Press, 137-155.

[42] Friedman 1970, 259.

[43] Friedman 1962, 135.

that doing so also harms the social stakeholder because society is best served by the market's invisible hand. Citing Smith and following Hayek's account of the market's virtues[44], Friedman contends that the conscious pursuit of the social good tends to lead to bad results, and is based on a number of flawed assumptions: first, it assumes that there is such thing as a "social good"; second, even if such a good exists, pursuing CSR assumes that any one person or group of people is capable of knowing what it is. The market's method of cooperation solves these problems, by substituting the "social good" for those ends that are produced by the intersection of various individual aims, and by pursuing it not through individual initiative but through the price mechanism's spontaneous organization. The payoff is that market actors deliberately pursuing social ends are less likely to benefit society than those who simply seek to maximize their own interests.

For Friedman the manager's pursuit of corporate profit is doubly ethical: it is ethical because it is in keeping with what he is hired to do and it is ethical because doing so will tend to benefit society. Similarly, the claim that the corporation is a social institution where managerial authority rules the day is wrongheaded for at least two reasons, both of which might be thought as enabling the very ills that critical managerialism is meant to address. On the one hand, thinking of the corporation as a social institution that ought to pursue social ends has the effect of undermining the market's ability to orient manager action to shareholder interest. Advocates of CSR concerned with managerial unaccountability are, in effect, creating the very separation of ownership and control they despise. On the other hand, thinking of the corporation as a social institution undercuts the best mechanism for putting resources toward their socially optimal end.

Agency Theory and Property Rights Theory

[44] Friedrich Hayek, "The Use of Knowledge in Society"

Taking the time to unravel the ethical logic of Friedman's claim is worthwhile as it brings into stark relief the normative nature of the economic theory of the firm developed by the next generation of Chicago economists. After all, while the ethical claim that Friedman makes has some bite to it, it rests on the assertion that the price mechanism works as he says it does, even when it comes to the corporation. But this is not such a simple assertion; as Coase argued in 1937, the corporation represents precisely the absence of such a price mechanism. Friedman's confidence in the market makes no sense if corporation is characterized by a set of relationships that are *not* directed by the market's price mechanism. What was needed was a way of taking the key Coasian insight that the development and expansion of the firm is a function of efficiency, and to divorce it from its basic analytic distinction between activity that happens in the market outside the firm and that which happens within it. Agency theory and property rights theory, the two key developments in the theory of the firm in the 70s and 80s, can be understood as providing the conceptual basis that would allow partisans of the free market to obviate such a distinction. This would allow them to cash in on Friedman's promissory note regarding the ethical nature of managerial profit-maximization.

In this regard it is interesting that Jensen and Meckling[45] actually reject a core feature of Friedman's argument in their famous contribution to the subject. Specifically, they reject the idea that the supposed separation of ownership and control is eliminated due to the disciplining effects of competitive markets. Competition amongst many firms cannot be a force for eliminating the separation of ownership and control, they correctly note, since this separation is characteristic of firms and public corporations generally; if all corporations feature a separation of ownership and control, then one enterprise won't be forced out of the market by virtue of such

[45] Michael Jensen and William Meckling. 1976. "Theory of the Firm: Managerial Behavior, Agency Costs, and Capital Structure." *Journal of Financial Economics* 3: 305-360.

separation. Put differently, competitive markets will actually serve to entrench such features, not nullify them.

Instead of rejecting the managerial claim that those who control the firm have great discretionary power relative to the vast majority of owners, agency theorists took on a different tack. Jensen and Meckling start by noting that most have approached the question of corporate control from a normative perspective—asking questions like "what is the best way of taming managerial discretion?"—and then contend that theirs is a positive theory: "we assume individuals solve these normative problems…we investigate the incentives faced by each of the parties and the elements entering into the determination of the equilibrium contractual form characterizing the relationship between the manager of the firm and the outside equity and debt holders."[46] The positive nature of the theory is purchased on the assumption that the market effectively produces the optimal result; it follows that the firm, as it exists, is the optimal result of freely contracting individuals, leaving merely the positive question of which incentives lead individuals to choose such results.

So, why is the separation of ownership and control preferable to other decision-making structures in most corporations? The answer, counterintuitively, is agency costs. This is counterintuitive because most—including, as we have seen, Berle and Means—have taken the existence of agency costs as being the knockdown argument *against* the separation of ownership and control. Agency theorists flips the script by beginning with a case in which agency costs are zero, namely a firm that is owned and managed by the same person/small group or, as Fama and Jensen refer to them, noncomplex organizations.[47] In such organizations the principal and the agent are the same actor, and so there is no divergence in interests and, therefore, no agency

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[46] Ibid 309-310.

[47] Eugene Fama and Michael Jensen. 1983. "Separation of Ownership and Control." *Journal of Law and Economics* 26.

costs. Agency costs arise when this actor needs more capital than that which is currently possessed, requiring that people contribute funds—either through debt or equity—and therefore turning the manager-owner into an agent who now works on behalf of various agents.

The agency relationship, put in this way, has an intuitive appeal, in that it allows someone to become a decision-maker of an enterprise even if they are not endowed with the large sums of money necessary to make them a manager-owner. Similarly, it allows for people with excess money to invest, to do so without having to take on the task of management. What agency theorists contributed here was the observation that various kinds of costs result from this type of relationship. Whereas Berle and Means focus primarily on the divergence of interests between the principal and agent, agency theorists noted that agency costs entail not simply this divergence of interests but the costs incurred in trying to mitigate this divergence. These costs—both of money and non-monetary resources like time—include the costs of principals to monitor or to control their agents ("monitoring costs"), the bonding costs that agents take on to give assurance to the principals ("binding costs"), and, finally, the residual losses imposed on the enterprise by virtue of the principals inability to fully act in accordance with the firm's interests ("agency costs" proper). While the latter at first appears to be a cost borne solely by the principal-investors, agency theorists contend that worries about such costs will be taken into account by would-be investors, thereby raising the cost for the manager to acquire more capital. The inability to fully resolve the principal-agent problem through bonding or monitoring therefore results in a cost for the manager as well as the investors.

The point of all of this is that the principal-agent relationship is not the win-lose transformation Berle and Means argue it is. Managers incur the cost of bonding and more expensive capital (while still getting the benefit of having capital being made available to him),

and investors gain the benefit of equity shares in an enterprise they don't need to manage (while incurring the cost of monitoring and managerial misdirection). The costs of agency are taken on because they represent improvements on the status quo—entrepreneurs with insufficient capital and investors with uninvested funds. Put differently, agency theorists like Jensen, Fama, and Meckling take the basic feature that concerned Berle and Means but recast it an economic, as opposed to a political, light; absent is the language of power, and in its place we find a calculation of costs and benefits that determine the optimal arrangement. The power imbalance that Berle and Means saw as representing a change in the system of property is thereby transformed into a series of contracts that are entered into because they tend to benefit all involved. The relationship between manager and investor is not a political one, but a contractual one in which all costs are taken into account: the misalignment of interests between principal and agent are reflected in costly monitoring and bonding mechanisms, and the cost of uncontrollable potential managerial indiscretion is reflected in the heightened cost of capital.

The agency theorist response to the Coasian view of the corporation, then, is that the entrepreneur *does no*t direct the firm through bureaucracy or authority. What Coase was actually discussing was a principal-agent relationship between entrepreneur-employer and the employee; employees are hired to do a particular thing in-house because the price-mechanism is ill equipped to induce the employee to do so. However, once hired, the entrepreneur is then in a position where he must deal with the fact that there is a divergence of interests between he and they; he must therefore expend costs monitoring them or employees will have to bear the costs of depressed wages because of their inability to fully assure the employer that they will not shirk in

their duties. Alchian and Demsetz refer to this as a "metering problem,"[48] and it is precisely the same dilemma faced by manager and shareholder.

The result is a view of the firm transformed from Coase and from Berle and Means, into one that is merely a nexus of contracts. The voluntarism implied by such a view radically recasts the received understanding of the employer-employee relationship, utterly removing any trace of "authority" that one might have thought existed:

> It is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market. This is delusion…It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people…. What then is the content of the presumed power to manage and assign workers to various tasks?...To speak of managing, directing, or assigning workers to various tasks is a deceptive way of noting that the employer continually is involved in renegotiation of contracts on terms that must be acceptable to both parties. Telling an employee to type this letter rather than to file that document is like my telling a grocer to sell me this brand of tuna rather than that brand of bread.[49]

What agency theorists like Fama, Jensen, and Meckling, and property rights theorists like Alchian and Demsetz, share is the anti-Coasian view that authority in the firm is a chimera. What goes on within the firm is the same thing that goes on outside the firm, namely agents contracting with other agents for goods and services. The only difference is that there is one fictional agent—the corporation—who is a common contractor with all other parties.

This allows for a specialization of knowledge and information that then helps all parties achieve their shared goals. Indeed, instead of seeing the employer as hiring the employee, this leads to the view that what the employer is really doing is selling his information to the employees who "are using him [the employer] to discern superior combinations of inputs."[50] The principal-agent nature of this is simply part of the cost of doing business, but does not imply any

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[48] Armen Alchian and Harold Demsetz. 1972. "Production, Information Costs, and Economic Organization." *American Economic Review* 62: 777-795. Reprinted in *The Collected Works of Armen A. Alchian Volume 2: Property Rights and Economic Behavior* (2006) Indianapolis: Liberty Fund, 151-178.
[49] Ibid 151-152.
[50] Ibid 174.

particularly distinct form of organization or organizing. For Alchian and Demsetz "the firm is a device for enhancing competition among sets of input resources as well as a device for more efficiently rewarding the inputs….the firm can be considered a privately owned market."[51] By focusing on the contractual nature of the relationship between the various corporate patron groups, these theorists effectively turn the firm into a market. This allows for the assumption that *within* the firm something akin to the price mechanism is essentially working as it ought, and the Hayekian conclusion that the organizational results are to be preferred because they reflect the optimal use of knowledge and resources. The separation of ownership and control is merely the efficient arrangement of freely contracting parties, and the optimized use of available information.

Indeed, property rights theorists go even further. Whereas agency theorists want to show that principal-agent relationships are both endemic and pervasive, and therefore that the separation of ownership and control is neither special nor scary, property rights theorists like Friedan want to deny such a separation. The property rights view holds that the most important determinant of how goods and services get allocated in a society is not a result of initial endowments, but the structure and integrity of the property rights assigned to such endowments. Important to this view is the idea that property rights are a bundle of rights, including the right to use, but also the right to profit from and the right to sell or destroy, a particular piece of property.[52] When we talk about a good or service being bought or sold, what we are actually talking about is a trade of some type of right over property X for another right over property Y. Thus the principals and agents—whether we are talking about shareholders and managers, or managers and employees—are actually just holders of different property rights. The shareholder

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[51] Ibid 177.

[52] Armen Alchian and Harold Demsetz. 1973. "The Property Rights Paradigm." *Journal of Economic History* 33: 16-27.

owns the right to residual claims of the corporation and to sell her share, while the manager owns the right to direct the use of corporate property; the manager possesses the right to direct the relationship amongst employees and resources, while employees possess the right to use corporate resources and a right to receive the wages they have contracted for. Far from the separation of ownership and control that obsessed Berle and Mean, property rights theorists contend that the firm is simply a bundle of different types of properties, with different parties contracting for different rights over them.

Thus, even divorced from the ability to exercise concrete control of the firm, investor-owners have the exit-option that allows them to shed their shares if their investments cease to return profits.[53] The existence of financial markets, where the demand for dividend-producing investments is met by investment opportunities competing with one another, imposes discipline on a firm's managers, for if they do not act on investor interests they will find themselves without investment. Far from being a problem, the diffusion of ownership allows for an effective finance market to open, which offers the ability to control the firm through the power of the purse. The property rights paradigm holds both that managerial power does not exist and that there is already an institution capable of directing the corporation: the market. The market for securities and the labor market for managers disciplines the corporate manager to act in the interests of the enterprise; his actions could lead to losing out on necessary equity capital, or could lead to him being fired and replaced by a more loyal agent.

This brings us back to Friedman's initial claims: that the separation of ownership and control does not exist, and that the social responsibility of managers was to pursue corporate profit. Thinkers like Alchian and Demsetz vindicate the first claim by recourse to a more subtle understanding of property rights; the second claim is substantiated by agency theorists and

[53] Harold Demsetz. 1967. "Toward a Theory of Property Rights." *American Economic Review* 57(2): 347-359.

property rights theorists who argue that there is no such thing as managerial power and therefore no such thing as managerial social responsibility. All there is are a series of contracts binding together principals and agents, contracts that not only create a legal duty to uphold the contract, but that also instrumentally serve to allow for an efficient allocation of knowledge, goods, and services in a market at equilibrium. The manager's duty is to increase the profits of the firm because that is what he has contracted himself to do. Furthermore as a market actor—since firms are simply markets by another name—following through on the transaction he has contracted to do contributes to a welfare-maximizing, optimal market outcome.

The Nexus-of-Contracts and Corporate Law

Managerialism's political conception of the corporation—where managerial power presented a social challenge requiring mechanisms of social accountability to solve—is dissolved into a voluntary and contractual relationship capable of being explained solely in terms of efficiency. Friedman's initial claim, that corporate executives are agents of their shareholders and have a sole ethical duty to pursue profit maximization on their behalf, was taken and generalized by agency theorists and property rights theorists such that all relationships within the corporation could be understood as market transactions; while some act as agents for others, all possess a different set of property rights so as to effect an efficient allocation of rights to use, profit from, and sell different aspects of the corporate enterprise. Power, authority, representation—these are not merely downplayed in favor of an emphasis on efficiency, but obviated by this transactional account.

We are now in a position to appreciate how these theorists set the stage for contemporary practices of corporate law and governance. While there are a number of works—running the

gamut from journal articles, newspaper editorials, and judicial rulings—that articulate these normative visions, the canonical work, which we might think of as the modern Chicago version of Berle and Means' book, is Easterbrook and Fischel's *The Economic Structure of Corporate Law*. Frank Easterbook in particular is the touchstone for contemporary corporate law, being himself a judge famous for his activist interpretations of statute and precedent in favor of the Chicago economics project. Informed by the foregoing economic theories, Easterbrook and Fischel contend that the corporate form as we know it is the end-result of years of testing and adaptation in the service of efficient organizing. This leads them to the view that corporate law should be conceived of as an extension of contract law: since the corporation is composed of voluntary relationships, we assume that these relationships are entered into after explicit or assumed terms have been negotiated, or proposed and accepted. The corporation is a legal fiction that stands in for the nexus of contracts with which each corporate party transacts: when one invests in, or works for, the corporation, what one is saying is that they are merely contracting with everyone else contracting with "the corporation."

The result is a principled ambivalence toward how internal relationships within the corporation are organized: "just as there is no right amount of paint in a car, there is no right relation among managers, investors, and other corporate participants. The relation must be worked out one firm at a time."[54] The result is that corporate law is not to be seen as prescribing some perfectionist ideal of organization, but as serving to facilitate the most efficient contractual arrangements for a given organization.[55] Corporate law, we might say, serves as a store of solved problems, a pre-made set of "off-the-shelf" contractual rules, justified from the perspective of economic efficiency, that save corporate parties from having to draw up contracts each time.

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[54] Frank Easterbrook and Daniel Fischel. 1991. *The Economic Structure of Corporate Law.* Cambridge: Harvard University Press, 14.
[55] Ibid 15.

There is a subtle ambiguity here. On the one hand corporate law views the corporation as a set of contracts that people have actually negotiated, explicitly or tacitly. On the other hand, there is an idealized aspect to their economic analysis, where we are to see existing statutes as the terms "people *would have* negotiated." That is, the corporation is the result of actual contracts but is also structured by principles derived from hypothetical contracts, reminiscent of the social contracts of liberal political philosophy. Without belaboring the point, the hypothetical nature of the contract is important because to imagine a hypothetical contract that hypothetical parties "would" agree to, we must impute certain motives to them. For Easterbrook and Fischel that motive is clear: "Money. They [investors and other participants in the corporation] therefore would agree unanimously to whatever rule maximizes the total value of the firm."[56] This would seem to fit in with the original Friedman argument that the sole duty of the corporation is to maximize profits (assuming, for simplicity's sake, a simple correlation between profit and value). It would also seem to provide grist for the critics' mill, who argue that corporate law is responsible for the psychopathic pursuit of profit that we see in modern corporate institutions.[57]

How are Easterbrook and Fischel able to assert both the enabling, non-directive quality of corporate law, while imputing this maximand to all parties of the corporate contract? We must note that they assert hypothetical value-maximization, but *not* as grounds for trumping corporate contracts as we find them. Despite whatever theoretical grounds we might have to believe that a certain form of organization might be more efficient than others, Easterbrook and Fischel claim that there is little basis to be found in corporate law to trump agreed-upon arrangements in service of profit-maximization. In the contractual approach to corporate law, the maximand of corporate value might be said to be *presumed* as opposed to imputed: the ready-made contracts

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[56] Ibid 23.
[57] Joel Bakan. 2004. *The Corporation*: *The Pathological Pursuit of Profit and Power*. New York: Free Press.

that corporate law provides are furnished from the presumption that agents seek to maximize the value of the corporation since doing so will tend to reduce agency costs. To posit a more complex maximand that combines various types of objectives would only assure that none of those objectives are met, since a manager can always cite the pursuit of one duty as an excuse for his neglect of another.[58] Maximizing value is the presumed maximand both because it tends to be what parties want, and because it tends to lower costs resulting from the corporate form.

However, this does not prescribe that corporate parties *must* pursue these terms. In the end, a given corporation can pursue whatever it wishes.[59] Corporate law merely provides an operational assumption for corporations, absent explicit contractual terms that stipulate some other goal. The operational assumption is profit maximization but this need not be construed as mandatory. Indeed, from a normative perspective it cannot be. The perspective of Pareto efficiency is that an externality-free voluntary transaction is always a gain in efficiency, since it appears to signal that at least some party prefers the allocation resulting from the transaction to the pre-transaction allocation, while no party saw it as making him worse off than he was before the transaction.[60] As such, if a corporation decides not to seek a profit at all, but manages to survive because people continue to transact with it, we have a good reason to believe that the corporation is actually promoting efficiency in the aggregate, despite appearances (or, perhaps, presumed intentions) to the contrary.

The nexus-of-contracts view of the corporation takes efficiency to be the normative foundation for corporate organizing. To this end it presumes that corporate parties wish to

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[58] Ibid 38.

[59] "What is the goal of the corporation? Is it profit, and for whom? Social welfare more broadly defined? Is there anything wrong with corporate charity? Should corporations try to maximize profit over the long run of the short? Our response to such questions is: who cares?" (Ibid 35).

[60] Jensen (2002. "Value Maximization, Stakeholder Theory, and the Corporate Objective Function." *Business Ethics Quarterly* 12: 235-256) cites this specifically in his defense of the Chicago view, and which I have further elaborated elsewhere (Abraham Singer. 2013. "What is the best way to argue against the profit-maximization principle?" *Business Ethics Journal Review* 1(12): 76-81).

maximize value. However, it does not mandate this as a goal; whatever contractual form a particular corporation takes, corporate law is to take a deferential approach and generally refrain from intervening or trumping existing contracts. While nudging corporations toward the maximand of shareholder value by making it the default operational assumption, the contractual approach to corporate law assumes that whichever contractual arrangements parties take on is, in the long run, good for promoting efficiency, absent heinous third party costs or fraud, all of which are best handled by standard contract law or tort law.

This brings us full circle back to the practices with which we began this paper. Why is shareholder control so impotent and the legal enforcement of fiduciary responsibility so mealy-mouthed? They all result from this contractual and efficiency-based understanding of the corporation.

Shareholder Voting

Easterbrook and Fischel break up the question of shareholder voting into three separate questions: Why is there voting in the first place? Why do shareholders in particular get the vote? And (why) do shareholders exercise their votes? As might be expected from their emphasis on efficiency, none of the answers to these questions have anything to do with "democracy" or "autonomy." Instead, voting rights are viewed as the rights allocated for the purpose of specifying terms that are left underspecified by existing contracts or by corporate law.[61] Put differently, voting is a means of reducing the agency costs that result from subjective interpretation of vague contractual terms. To avoid the costs that would result from interpretive disagreement, one class of patrons is given the vote and the power to specify the unspecified.

[61] Easterbrook and Fischel, 66.

Contrary to Berle and Means, the idea of control is severed from an ideal of what ownership of property entails. The justification for shareholder voting is not due to their being "owners" and entitled to controlling the enterprise. Shareholders are given voting rights simply because it is generally most efficient to allocate such rights to them; they have the right incentives, receiving "most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion….The right to vote follows the residual claim."[62] Shareholders are the voting class because they tend to be the group best positioned to exercise such rights. This does not imply that they always must be: corporations are free to assign voting right to whomever they wish, and indeed doing so can tend to achieve efficiency gains in the decision-making process.[63] But it explains why corporate law presumes that the residual claimant (that is, the shareholder) will be the one possessing the right to vote.

This account helps to explain something else about shareholder voting, namely why shareholders tend not to do it very often. Just as Berle and Means noted, shareholders tend to be numerous and dispersed, making the attempt to control the actions of management in any real way difficult and costly. For this reason, even when shareholders do vote, it is generally either to delegate decision-making ability or to affirm that which has been presented to them by those they have delegated. The difference, of course, is that the nexus-of-contracts view finds nothing wrong with this. Because the end of shareholder voting is not some ethical ideal of property ownership, but merely the further specification of contractual terms, there is no problem with a passive shareholder class; they have served their function by delegating their decision-making authority to management, which is in a better position to gather information and dedicate the necessary time and resources for making the best decisions for the corporate venture. As a result,

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[62] Ibid 68-69.

[63] For the definitive account of this variety of ownership assignments see Henry Hansmann. 1996. *The Ownership of Enterprise*. Cambridge: Harvard University Press.

exit is favored over voice: access to the securities market is favored by the contractual approach as the best means for shareholders to check the directives of management. Governance is best handled by the market for ownership as opposed to mechanisms of democratic control.

As a result, Easterbrook and Fischel heavily criticize attempts to bolster or vitalize shareholder democracy. The proxy rules implemented and upheld by the Securities and Exchange Commissions are a case in point. These rules mandate disclosure of various types of information to shareholders on the assumption that shareholders inactivity is due to their being on the losing end of an information asymmetry. This is where the presumption of voluntariness in corporate affairs, and a strong disinclination towards meddling with such affairs, is brought into stark relief. With regards to these issues of shareholder voting, Easterbrook and Fischel are unequivocal:

> The rational strategy for most dissatisfied shareholders is to sell rather than incur costs in attempting to bring about change through votes. There are, however, good reasons why investors would choose to limit both the scope of voting and the information supplied: rational ignorance implies delegation implies less voting; and the costs of information imply limits on disclosure to investors who won't act on information even if they possess it.[64]

Calls for more shareholder voting, mandatory inclusion of shareholder proposals, and greater access to information are just different examples of forcing onto shareholders that which they evidently don't want, since if they wanted it they would do it. Foisting an ideal of democracy onto shareholders only serves to reduce the welfare of shareholders who already currently pursue the rational strategy of passivity.

Advocates of shareholder democracy or shareholder activism are operating on a category error for contractualists like Easterbrook and Fischel, in that they assume that shareholders' right to vote implies that democracy is somehow a value in and of itself in the corporation. But the

[64] Ibid, 82-83.

question of corporate governance is merely the question of how "suppliers of finance to corporations assure themselves of getting a return on their investment."[65] Given that the corporation is merely a nexus of voluntary contracts, contemporary corporate law should assume that such contracts represent the most efficient means for the parties to pursue their interests.

Managerial Responsibility and Fiduciary Duty

Another mechanism in corporate law that is meant to reduce agency costs and contracting costs is the principle of fiduciary duty. By stipulating managerial fiduciary duty, corporate law requires that managers act in ways neither stipulated by contract nor directed by shareholders, but according to a general principle of duty that attaches to their position. Determining the content of fiduciary duties is a matter of approximating "the bargain that investors and managers would have reached if they could have bargained at no costs."[66] One should note here that this is essentially the Coase Theorem applied to corporate law. Cast in such a matter, the conceptual domain of fiduciary duty is limited to those activities that enhance the welfare of shareholders. To see fiduciary duty as somehow either trumping existing contracts, or including values other than those expressly stated in contracts, is to miss the point that fiduciary duties serve an efficiency-function similar to voting rights: they specify that which is underspecified or would be costly to specify, in contracts. "Fiduciary duty" simply performs this function by deterrence: managers know that if they violate their fiduciary duties they can be held legally accountable.

Immediately this precludes wider views of corporate responsibility to be included within a manager's fiduciary duties. Shoehorning a thick sense of managerial social responsibility into the fiduciary principle only serves to increase agency costs, and thus undercuts its purpose of

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[65] Jean Tirole. 2006. *The Theory of Corporate Finance*. Princeton: Princeton University Press, 16.
[66] Easterbrook and Fischel 92.

economizing on explicit contractual terms. Yet this analysis suggests an even more radical result. The economic rationale of the fiduciary principle not only restricts managerial responsibility to maximizing shareholder value; it implies that even such a restricted principle should rarely be enforced. Easterbrook and Fischel come to this conclusion by putting a heavy emphasis on the "business judgment rule," which says that courts should start with the "presumption that a firm's directors have, in fact, met their duty of care."[67] Even if corporate executives implement a patently absurd strategy, or make disastrous decisions, they are protected by the business judgment rule as long as there is no clear and obvious conflict of interest or gross negligence; or, as Blaire and Sout have put it: "a director is more likely to be hit by lightning after leaving her board meeting than she to pay damages."[68]

The business judgment rule thus serves to protect managers from suffering the consequences of violating what would otherwise be their fiduciary duty to do. Put more strongly, the business judgment rule minimizes the idea of fiduciary responsibility to the point where it only prohibits clear-cut cases of fraud or self-dealing.[69] What could the economic rationale be for *not* enforcing the managerial responsibility to maximize shareholder value? According to Easterbrook and Fischel, the explanation for this doctrine is the same as the explanation for why shareholder do not (and should not be forced to) exercise their votes: for shareholders it is more costly to uphold contracts through courts and liability rules than to just defer to managers or sell one's shares. Litigation can be expensive, time-consuming, and reach inaccurate conclusions. Furthermore, judges do not have the type of business expertise that corporate executives have

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[67] Lynn Stout. 2002. "In Praise of Procedure: An Economic and Behavioral Defense of *Smith v Van Gorkom* and the Business Judgment Rule." *Northwestern University Law Review* 96(2): 680 (675-693).

[68] Margaret Blair and Lynn Stout. 2001. "Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law." *University of Pennsylvania Law Review* 149: 1791 (1735-1829).

[69] And, even then, only rarely as Easterbrook and Fischel note approvingly (98, 104).

and the labor market for managers will more efficiently and reliably weed out ineffective management practices than legal liability rules.[70]

All of this is to say, the deference to managers implied by the business judgment rule is underwritten by the same principle that explains why fiduciary duty is to be interpreted as only implying maximizing shareholder wealth: to do otherwise raises the costs of doing business, which is precisely what corporate law tries to mitigate. From a contractual perspective, the substance of the fiduciary principle implies its own limited application.[71] This is all in fitting with the general framework: if we start with the assumption that markets and voluntary transactions tend to maximize efficiency, and if we view the corporation as simply a nexus of voluntary market transactions, then it follows that that set of arrangements we find in corporations will tend to be most efficient over the long run. Therefore, absent an explicit contract or agreement that stipulates not to do a particular action, corporate law should largely be in the business of deferring to business, or to those contractually placed as decision-makers.

It again should be noted that this cuts in a number of directions. Whereas Friedman argued that corporate charity was an example of managerial irresponsibility, or even small-scale socialism, the contractual view contends this is mistaken. If managers wish to use corporate funds for charitable reasons, for example, it is not a violation of the fiduciary duty to pursue profits, despite appearances to the contrary. Charity *might* create goodwill with the community that might reduce costs down the road; buying floor-side tickets at a basketball game *might* be the thing that lures top talent to the firm. The point is that there is no way to be sure, and so courts are to defer. As a result, and in keeping with what was said earlier, corporate executives are perfectly free to pursue whatever ends they wish under a contractual view of the corporation.

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[70] Ibid 100.
[71] Ibid 108.

They are in fact under no fiduciary duty to pursue profits or maximize value.[72] We can summarize the nexus-of-contracts view of fiduciary duty and managerial responsibility in the following way: *the only duty that management has is the duty not to do that which they said they wouldn't do.* There is no greater or overarching ethical or legal principle that directs executive activity other than the duty to uphold contracts. Lee[73] has therefore concluded that in the contractual view of the corporation, corporate social responsibility or ethical business is not the purview of management but of the shareholder. Shareholders can collectively impose a more ethically thick duty upon management. Of course, it is difficult for shareholders to pursue such an agenda since the contractual view suggests that the collective action problems rendering shareholders passive ought not to be changed by legal fiat, as it would constitute an efficiency-loss. Thus while corporate objectives other than profit are perfectly acceptable to the contractual view, they advocate a legal regime that makes it incredibly difficult for such objectives to be implemented. Despite their differences with Friedman's principled defense of profit-maximization, the contractualists' view of corporate governance winds up justifying a type of corporate practice that is very much in line with Friedman's vision.

Conclusion

Considering the Chicago tradition from the perspective of the corporation brings to light key aspects of how it conceives the relationship between institution and individual. Underlying Chicago's approach to both the productivity and normative components of the corporation is the assumption that individuals' preferences are exogenous to the economic institutions that

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[72] The idea that there is a legal requirement for corporations to maximize profits or shareholder value is challenged most forcefully here: Lynn Stout. 2008. "Why we Should Stop Teaching Dodge V Ford." *Virginia Law and Business Review* 163-190.

[73] Ian Lee. 2005. "Corporate Law, Profit Maximization, and the Responsible Shareholder." *Stanford Journal of Law, Business, and Finance* 10(2):31-60.

facilitate their cooperation. Inherent to Friedman's business ethics, agency theory and property rights theory, and Easterbrook and Fischel's account of corporate law is the idea that individuals are seeking to satisfy their preferences through exchange and through the legal machinery that enables specialized forms of productive cooperation. This is essentially the "utility maximizing" assumption at work. What we see in addition to this assumption is the idea that individuals' preference exist independently of, and are largely unaffected by, the institutions that coordinate their activity. Viewing the corporation as a nexus of contracts, which is justified because it represents the preferred and efficient organization of freely contracting individuals agents, commits Chicagoans to an assumption that the preference schedules of those agents are a given. This idea was given formal articulation in one of Chicago's most famous and controversial papers, "De Gustibus Non Est Disputandum," where Stigler and Becker argue that tastes and preferences are fixed both for an individual throughout time, and for individuals across time.[74] This assumption is crucial for the Chicago project to work. To concede that individuals' preferences may be endogenous and affected by economic institutions would render question-begging the normative claim that such institutions are preferable because they are efficient, since we would want to know why satisfying such affected preferences is desirable in the first place.

Such an assumption, however, is incoherent, as is the idea that the corporation could be conceived as a market. Indeed, if corporations and firms were merely markets this raises the question as to why we have corporations in the first place. Why don't people just contract individually through the market's price mechanism, instead of creating these "privately owned markets"? There must be something about what is going on within the corporation that

[74] George Stigler and Gary Becker. 1977. "De Gustibus Non Est Disputandum." *American Economic Review* 67(2): 76-90.

distinguishes it in kind from the market. I conclude here with a brief story of what can account for this better than the Chicago story.

Oliver Williamson famously contended—to put it briefly—that one of the key inefficiencies created by markets is due to opportunism, or "self-interest seeking with guile."[75] Because people act opportunistically, there is always the possibility of deception, particularly about one's preferences and intentions. I might contract with you to do a particular service, and then once you are depending on me to do it, I refuse to do it unless you pay me more. I might have you learn a particular skill for a task I need done and then, after you have spent time learning that skill, pay you less for it since you are now dependent on my employment of those skills. The fear of opportunistic behavior in the economy will foreclose whole classes of goods and services from being offered because doing them depends on the type of cooperation that is made difficult by opportunistic behavior. Governance structures like corporations, says Williamson, exist because they are able to overcome these costs or, as Osterloch and Frey put it, "opportunism is a strong form of extrinsic motivation when individuals are not constrained by any rules. In the transactions cost view, the task is to establish institutional settings that mitigate the hazards and costs of opportunistic behavior."[76]

The question is how firms as institutions mitigate these hazards. For economically-oriented theories like Chicago, the only answers forthcoming can be found in the incentives such institutions offer. Because of this approach, they take the incentives offered by corporate managers and those offered by the price mechanism as analogous, which is how they can view the corporation as a market. The answer, I propose, is that firms are able to economize over market transactions because they introduce cooperative norms that are crowded out by the

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[75] Williamson, *Economic Institutions of Capitalism*, 47.
[76] Margit Osterloch and Bruno S Frey. 2000. "Motivation, Knowledge Transfer, and Organizational Forms." *Organization Science* 11(5): 539

market. the basic idea of "crowding out" is that people are motivated both extrinsically—that is, by material rewards gained by consequence of an action—and intrinsically—by doing the action itself; as extrinsic incentives for action increase, other intrinsic incentives are "crowded out," making them less salient in determining action.[77] While competitive pricing is able to work its information-producing magic because of the external and monetary rewards it promises to individuals who heed its call, the firm is necessary precisely because such incentives also create problems. Firms suspend the price mechanism in order to bring more intrinsic motivation to bear, creating environments that can facilitate the development of trust,[78] cooperation,[79] and the procurement of asset-specific investments.[80]

The corporation is distinct from a market not just in institutional structure (management vs. price-mechanism, public vs. private) but in the norms and social rules that govern behavior therein (strategic/adversarial vs. normative/cooperative). This is actually in keeping with Friedman's earlier point about the necessity of profit-maximization to the market; my point here is simply that that cannot be the case with the corporation. To put it in loftier language, the rational choice account of institutions—where institutions are understood in terms of the incentives and disincentives they offer—is ill-suited for the firm since the firm comes into

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[77] Bruno S. Frey and Reto Jegen. 2001. "Motivation Crowding Theory." *Journal of Economic Surveys* 15(5): 590.

[78] Francis Fukuyama. 1995. *Trust: The Social Virtues and the Creation of Prosperity.* New York: Free Press (particularly chapters 17 and 20); *Francis* Fukuyama. 2001. "Social Capital, Civil Society, and Development." *Third World Quarterly* 22(1): 15 (which discusses the linking of trust, social capital, and paying more than market worth).

[79] Abigail Barr and Pieter Serneels. 2009. "Reciprocity in the Workplace." *Experimental Economics* 12(1): 99-112; Steffen Huck, Dorothea Kubler, and Joergen Weibull. 2012. "Social Norms and Economic Incentives in Firms." *Journal of Economic Behavior and Organizations* 83: 184.

[80] See George A. Akerloff and Rachel E. Kranton. 2005. "Identity and the Economics of Organizations." *The Journal of Economic Perspectives* 19(1): 9-32. For instance: "many monetary incentive schemes create opportunities for workers to game the system…People respond almost too well to monetary incentives. That is, firms get what they pay for, but since the schemes cannot be targeted well, what firms get is often not what they want. These problems indicate that if an organization is going to function well, it should not rely solely on monetary compensation schemes" (11).

existence precisely to address collective problems that cannot be addressed by extrinsic incentives alone.

For this reason, firms are better understood in terms of the sociologically-informed idea that "institutions influence behavior by providing the cognitive scripts, categories and models that are indispensable for action."[81] In contrast to Chicago-style theories of how institutions provide incentives and disincentives to coordinate action, this sociological view focuses on how notions of legitimacy and socialization are used to coordinate individuals in groups, often without those individuals being aware.[82] Significantly, such a view requires that individual preferences not be considered exogenous, since institutions function precisely by virtue of their ability to affect preferences and behavior through means other than extrinsic incentives. Once this is recognized the idea of the corporation as a nexus of contracted principal-agent relationships where power does not exist becomes less tenable. The corporation's efficiency is precisely the result of non-economic factors being brought to bear on corporate productivity. To use efficiency and markets as a means of deflecting social and political critiques of corporate structures, as Chicago theorists do, is to ignore that these normatively thick social concepts are what is underwriting corporate efficiency in the first place.

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[81] Peter Hall and Rosemary Taylor. 1996. "Political Science and the Three New Institutionalisms." *Political Studies* 44(5): 951.

[82] Gregory Jackson and Tim Muellenborn. 2012. "Understanding the Role of Institutions in Industrial Relations: Perspectives from Classical Sociological Theory." *Industrial Relations* 51(1): 476.